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No. 91-794

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In The

Supreme Court of the United States

October Term, 1992

HENRY HARPER, et al.,

Petitioners,

v.

VIRGINIA DEPARTMENT OF TAXATION,

Respondent.

On Writ Of Certiorari To
The Supreme Court Of Virginia

BRIEF FOR RESPONDENT

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QUESTION PRESENTED

Whether federal law compels the Virginia Supreme Court to interpret its tax refund statute in such a way as to require refunds to Petitioners for taxes paid prior to this Court's decision in *Davis v. Michigan Department of Treasury*, 489 U.S. 803 (1989).

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STATEMENT OF THE CASE

On the day *Davis v. Michigan Department of Treasury*, 489 U.S. 803 (1989) ("*Davis*"), was decided, Virginia law contained what had been thought for almost 50 years to be a fair and reasonable provision excluding from taxable income retirement benefits paid by the State to its former employees. Va. Code § 58.1-322(C)(3) (1950); *see* Ch. 325, 1942 Va. Acts 481, 500 (Reg. Sess.). The exclusion was adopted as an alternative to (and what was thought the functional equivalent of) additional retirement compensation to the State's former employees. It was not challenged by anyone, including the taxpayers now before this Court, during the nearly half century between its adoption and the decision in *Davis*.

Davis held that this type of tax violated federal law. At least 23 states had similar statutes, well over half of the 41 that have a personal income tax. All states moved to conform their laws to the newly-stated *Davis* requirements. In Virginia, then-Governor Baliles called a Special Session of the legislature within weeks of the decision. The specific exemption for state and local government retirement income was repealed, effective for taxable years beginning on or after January 1, 1989, and a system of taxation for pensioners' income indisputably acceptable under *Davis* was enacted in its stead.

Following the corrective action by the Virginia legislature, Petitioners filed suits in state court against the Virginia Department of Taxation (hereafter "Commonwealth"), seeking refunds for state income taxes paid on their federal retirement income for the pre-*Davis* taxable years of 1985, 1986, 1987, and 1988. The estimated potential refund liability Virginia faces for the still viable claims of its approximately 200,000 federal retirees – not all of whom are parties to the present lawsuit – is over $467 million. This is the equivalent of the income that would be produced in one year from a 22% increase (from 4.5% to 5.5%) in Virginia's sales tax or, alternatively, a 13.6% surcharge on the 1991 income tax bill of every individual taxpayer. It is more than the entire annual

budget for Virginia's Department of Corrections or, alternatively, more than the annual state general fund appropriation for Virginia's three largest state Universities. The estimated total refund liability of all states with pending *Davis*-based litigation is more than $1.8 billion. (*See* Supplemental Appendices to this Brief ("SA") at SA 1-3.)

Petitioners base their claim for relief on Va. Code § 58.1-1826 (1991), which provides that the state courts "may" order refunds "[i]f the court is satisfied that the applicant is erroneously or improperly assessed with any taxes." As elaborated below, this language has been interpreted by the Virginia Supreme Court – in cases that arose long before *Davis* and its resulting litigation – not to mandate refunds when a tax is unexpectedly overturned as unconstitutional. As also elaborated below, a pre-payment remedy was available to these taxpayers (had they thought to object to the taxes before *Davis* and before the taxes were paid) by application to the State Tax Commissioner.

The state trial court denied Petitioners' refund claims. In *Harper v. Virginia Department of Taxation*, 241 Va. 232, 401 S.E.2d 868 (1991) ("*Harper I*"), the Virginia Supreme Court affirmed on two independent grounds, one based on federal law and one based on state law. The federal ground was that *Davis* need not be applied retroactively and, thus, does not provide the basis for refund liability. The state law ground, based on pre-*Davis* precedent discussed below, was that the state remedy provided in § 58.1-1826 is not available on the facts presented. No challenge to this state ground of decision was made by Petitioners in their petitions for certiorari.

Petitioners sought certiorari in this Court from *Harper I*. After its decision in *James B. Beam Distilling Co. v. Georgia*, 111 S. Ct. 2439 (1991) ("*Beam*"), this Court granted certiorari in *Harper I* and vacated and remanded for further consideration in light of *Beam*. The Virginia Supreme Court held that *Beam* did not require a different result and reaffirmed its former decision "in all respects." *Harper v. Virginia Department of Taxation*, 242 Va. 322, 327, 410 S.E.2d 629, 632

(1991) ("*Harper II*"). This Court granted the present writ of certiorari following the decision in *Harper II*. (For the convenience of the Court, both *Harper I* and *Harper II* are reproduced in Appendix B to this Brief, SA 4-19.)

SUMMARY OF ARGUMENT

In order to prevail on their refund claim, Petitioners must establish two independent propositions. The first is that the pre-*Davis* tax violated a federal right. The Virginia Supreme Court held that no federal rights were violated because *Davis* need not be applied retroactively to taxable years that were completed before *Davis* was decided. The second is that the state remedy sought by Petitioners is available to them. The Virginia Supreme Court held that the state remedy invoked by Petitioners is not available whether or not *Davis* is to be applied retroactively. Prior decisions of this Court establish that questions of remedy in this context are controlled by state law, subject to the normal requirements that the state law ground for decision be "adequate" and "independent." These requirements are satisfied here.

At bottom, the Commonwealth's argument is that, at some point in the analysis, federal law permits equitable considerations to control the availability of refund relief in the present context and that such considerations overwhelmingly support the conclusion that refunds of pre-*Davis* taxes are not necessary to accomplish the objectives of federal law in this sphere.

The first opportunity to take equitable considerations into account is in determining whether the principles of *Chevron Oil Co. v. Huson*, 404 U.S. 97 (1971) ("*Chevron Oil*"), are to control whether *Davis* must be applied retroactively. The Commonwealth's argument in this respect is that the *Chevron Oil* formula should be applied to the present case, and that its application is not foreclosed by this Court's decision in *Beam*. *Davis* established a "new" principle of law as that term is used in *Chevron Oil*, and the remainder of the *Chevron Oil*

principles establish that it would be inappropriate to apply *Davis* retroactively.

The second opportunity to take equitable considerations into account – even if *Davis* is to be applied retroactively – is in determining whether the Commonwealth is obligated to provide to Petitioners the particular state remedy they sought below. The Virginia Supreme Court held that this remedy was unavailable for reasons well-established in prior state law. There are two reasons why this conclusion is unassailable. The first is that prospective relief is a sufficient remedy under applicable federal due process principles. The second is that federal due process principles do not in any event require a post-payment refund remedy in situations where a pre-payment remedy was available to the taxpayer.

ARGUMENT

THE SUPREME COURT OF VIRGINIA PROPERLY HELD THAT PETITIONERS ARE NOT DUE REFUNDS FOR STATE TAXES ASSESSED ON THEIR FEDERAL RETIREMENT INCOME PRIOR TO THE DECISION IN *DAVIS*.

I. Application of the *Chevron Oil* formula leads to the conclusion that *Davis* does not apply to taxable years concluded before that decision.

A. This Court's decision in *Beam* does not preclude the application of *Chevron Oil* to the *Davis* decision.

An argument made by the Petitioners must be set aside at the outset. The conflicting rationales underlying this Court's decision in *Beam* support the conclusion that "selective prospectivity" is no longer an option. That is, it would not be appropriate for federal law to dictate the application of *Davis* retrospectively to the litigant before the Court in *Davis* but not to Petitioners. Petitioners seize upon this point to argue that since the Court applied the holding in *Davis* to its parties, it must now do so here. Petitioners' Brief ("Pet. Br.") at 3-4, 6-10.

This argument, of course, begs the central question whether the Court did in fact apply its *Davis* holding retrospectively to the litigant before the Court in *Davis*. A careful examination of the question begged by the Petitioners' argument shows that, as the Virginia Supreme Court twice found,[1] this Court did not resolve the federal issue of retroactivity in *Davis*. Neither did it in *Barker v. Kansas*, 112 S. Ct. 1619 (1992).

In the first place, the question whether federal law commanded retroactivity was not contested in *Davis*, nor even mentioned by the parties, by the amici, by the Court, or by the dissent. What the Court said, after concluding that the tax at issue in *Davis* violated principles of intergovernmental tax immunity, was: "The State having conceded that a refund is appropriate in these circumstances, see Brief for Appellee 63, to the extent appellant has paid taxes pursuant to this invalid tax scheme, he is entitled to a refund." *Davis*, 489 U.S. at 817. This is all the Court said. Yet Petitioners argue that this one sentence resolves an issue that was not before the Court, that was not considered or discussed by parties or by the Court, and that creates a potential liability of more than $1.8 billion to be imposed on innocent taxpayers in 23 states.

This simply cannot be true. This Court does not conduct its affairs in such cavalier fashion. Courts do not act reflexively or arbitrarily. It would be unconscionable for this Court to resolve an issue of such importance to so many taxpaying citizens of so many states without the benefit of any briefing, argument, thought, analysis, or consideration. This Court simply does not – and, of equal importance, cannot be perceived to – work in a manner that is so fundamentally at odds with the principles of fair play underlying the concept of due process of law. Whatever the right outcome of this case, the answer cannot be that there are no issues to be argued because

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[1] On remand, the Virginia Supreme Court reiterated its earlier determination (*Harper I*, 241 Va. at 235 n. 1, 401 S.E. 2d at 870 n.1) (SA 5), that "the issue of retroactivity was not considered by the Supreme Court in *Davis* because Michigan previously had agreed to the payment of a refund to Davis if its taxing scheme were invalidated." *Harper II*, 242 Va. at 322, 410 S.E. 2d at 632. (SA 18).

the Court has previously resolved them without any evidence of having given the matter any thought or attention and without giving any affected parties the opportunity to be heard. This argument by Petitioners must be rejected.

Petitioners also, it can be added, misinterpret the stipulation made by Michigan in *Davis*. It is well established in the decisions of this Court – the point was clearly made in *McKesson Corp. v. Division of Alcoholic Beverages and Tobacco*, 496 U.S. 18, 52 n.36 (1990) ("*McKesson*") – that states are free to provide remedies that exceed the requirements of federal law. The fact that Michigan volunteered to supply Davis with a remedy for prior tax years does not mean that this Court addressed any issues with regard to federal requirements of retrospectivity. It is also well-established that this Court does not make gratuitous decisions, that it does not resolve important questions of federal law in advance of the necessity of resolving them. It is well within this tradition to regard the Court's one-sentence treatment of Michigan's concession in *Davis* as taking Michigan up on its volunteered remedy without passing on the question whether federal law required the payment of refunds to Mr. Davis.[2] In short, *Davis* can be "fairly read" *not* "to hold as a choice of law that its rule should apply retroactively to the litigants then before the Court." *Beam*, 111 S. Ct. at 2445.[3] While *Beam* rejected the

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[2] That this Court is not in the habit of resolving important questions without thought or consideration is also evident from its invitation last Term for amicus curiae briefs on the issue of retroactivity in the reargument of *Allied-Signal, Inc. v. Director, Div. of Taxation*, 112 S. Ct. 2251 (1992) ("*Allied-Signal*") (eight amicus curiae briefs were filed in *Allied-Signal* presenting arguments to the Court on the retroactivity issue; the Court did not reach the retroactivity question since it rejected the claim that would have raised it).

[3] Petitioners and some of the amici argue that *Davis* must have decided the retroactivity issue as a matter of federal law because, they say, *Beam* establishes that the question is always decided if not explicitly reserved. E.g., Pet. Br. at 10. They rely in making this argument on one sentence in *Beam* in a discussion the focus of which was not on whether an explicit reservation was a *sine qua non* of non-retroactivity. Essentially, the Court said that in context it made sense to read *Bacchus Imports, Ltd v. Dias*, 468 U.S. 264 (1984) ("*Bacchus*") as applying the rule of that case to the parties before the Court. There is no evidence on the face of the

option of "selective prospectivity," it clearly did not overrule *Chevron Oil*, and it expressly left open the possibility that "pure prospectivity" might apply in the *Davis* context. It is to this possibility that the Commonwealth now turns.

B. The *Chevron Oil* formula is fair and workable and should be preserved as the test for the retroactivity of new principles of law.

Constitutional doctrines do not always develop to the point that precedent predicts or even clearly hints at the result the Court ultimately reaches. *Chevron Oil* recognizes that the Supreme Court not only overrules precedent but also reaches results that are not ordained by prior law. Reference to the legal and factual landscape composing a body of law may fail to predict the course taken by the Court in a particular case.[4] When this occurs in a tax case, the burden of a rule of law that is "new" in this sense may fall on either the government or the taxpayer. Full retroactive application of the "new" rule could result in a refund of already budgeted resources or in the collection of unanticipated back taxes. *Chevron Oil* provides a method for accommodating unforeseen changes in the law without destroying reliance interests and settled expectations. It complements principles of *stare decisis* by

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Beam opinion that this Court meant to establish formal reservation as a litmus test. Even if it did, that itself would be the adoption of a "new" rule that could not fairly be applied to decisions, such as *Davis*, that were decided before *Beam*. The jurisprudential climate at the time *Davis* was decided does not support the conclusion that the Court's one-sentence acceptance of the Michigan concession was meant to resolve, or would have been fairly understood by the legal community at the time as necessarily resolving, retroactivity issues involving claims of states and individuals not parties to that suit.

[4] Unlike the interstate commerce clause, the intergovernmental tax immunity doctrine is infrequently the basis for a constitutional challenge to a state tax. The body of law in this area is thus scant, and the doctrine has been referred to as "a most esoteric of constitutional philosophies." *Bohn v. Waddell*, 164 Ariz. 74, 86, 790 P.2d 772, 784 (Tax Ct. 1990). *See also Swanson v. Powers*, 937 F.2d. 965, 968 (4th Cir. 1991), *cert. denied*, 112 S. Ct. 871 (1992) (doctrine of intergovernmental tax immunity "at best, ambiguous").

recognizing the values of stability and foreseeability in the law.[5]

Chevron Oil has proved to be a sound and workable rule of judicial decision-making. Appropriately, it has been employed only in rare circumstances where the impact of a "new" ruling would be especially burdensome to the justifiable reliance interests of one party or another. Even prior to *American Trucking Ass'ns v. Smith*, 496 U.S. 167 (1990) ("*ATA v. Smith*") and *Beam*, state courts had applied the equitable principles enunciated in *Chevron Oil* to determine the retroactivity of both state and United States Supreme Court decisions. These courts have found *Chevron Oil* to provide a workable solution to the retroactivity problem and have applied its test in a reasonable and responsible manner. *Compare American Trucking Ass'ns v. Conway*, 152 Vt. 383, 566 A.2d 1335 (1989) (Supreme Court decision retroactive under *Chevron Oil* because predicted by state case), *with Opinion of Justices*, 131 N.H. 644, 557 A.2d 1364 (1989) (state court decision not retroactive because it upset tax practice relied on by taxpayers and by state).[6] This Court too

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[5] This Court has consistently, and recently, acknowledged the importance of reliance interests when it is called upon to make changes in the law. In *Quill Corp. v. North Dakota*, 112 S. Ct. 1904 (1992), the Court refrained from overruling *National Bellas Hess Inc. v. Department of Revenue*, 386 U.S. 753 (1967), stating: "The interest in stability and the orderly development of the law that undergirds the doctrine of *stare decisis* . . . counsels adherence to settled precedent." 112 S. Ct. at 1916 (1992). But not every issue presented to the Court is resolved by "adherence to settled precedent." It is in such a case that, by limiting the backward reach of the new decision so as not to upset settled expectations, the approach of *Chevron Oil* achieves the same purpose as the doctrine of *stare decisis:* protection of the "interest in stability and the orderly development of the law."

[6] Other state courts besides New Hampshire's and Vermont's have found the *Chevron Oil* test an appropriate judicial tool for determining retroactivity. *See Private Truck Council, Inc. v. State*, 111 N.J. 214, 544 A.2d 33 (1988) (state's retaliatory truck tax violates Commerce Clause; state's prospectivity argument rejected without comment); *National Can Corp. v. Department of Revenue*, 109 Wash. 2d 878, 749 P.2d 1286, *cert. denied*, 486 U.S. 1040 (1988) (Supreme Court decision that invalidated tax repeatedly upheld by state court not retroactive; state justified in relying on earlier decisions); *Exxon Corp v. Hunt*, 109 N.J. 110, 534 A.2d 1 (1987) (Supreme Court decision retroactive because did not establish new

has found it appropriate to temper the burden of "new" rules by the adoption of limitations on the retroactive reach of its decisions. *Northern Pipeline Construction Co. v. Marathon Pipe Line Co.*, 458 U.S. 50 (1982); *Buckley v. Valeo*, 424 U.S. 1 (1976); *Hill v. Stone*, 421 U.S. 289 (1975); *Lemon v. Kurtzman*, 411 U.S. 192 (1973); *Phoenix v. Kolodziejski*, 399 U.S. 204 (1970); *Cipriano v. City of Houma*, 395 U.S. 701 (1969); *Allen v. State Bd. of Elections*, 393 U.S. 544 (1969); *England v. Louisiana State Bd. of Medical Examiners*, 375 U.S. 411 (1964); *cf. Teague v. Lane*, 489 U.S. 288 (1989), and its progeny.[7]

Chevron Oil does not require the Court to reject the traditional rule that judicial decisions are in general retroactive. But it allows the Court, in the extraordinary case, to temper the harshness of a strict rule of retroactivity. Use of the *Chevron Oil* approach is particularly appropriate in areas where a single decision of this Court introduces a far-reaching change in the law that imposes a dramatic new liability that was not foreseeable based on settled understandings that had accumulated over the years.[8]

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rule of law under *Chevron Oil*); *First of McAlester Corp. v. Oklahoma Tax Comm'n*, 709 P.2d 1026 (Okla. 1985) (Supreme Court decision invalidating tax on interest income not retroactive because of lack of foreseeability); *Salorio v. Glaser*, 93 N.J. 447, 461 A.2d 1100, *cert. denied*, 464 U.S. 993 (1983) (decision not retroactive based on justifiable reliance on long-standing unchallenged statute).

[7] The Commonwealth recognizes that there is debate on the Court as to whether these decisions stem from choice-of-law or remedial principles. *See, e.g., Beam*, 111 S. Ct. at 2443-44. The important point underlying the Commonwealth's position in this case is that the principles recognized in *Chevron Oil* be considered at some point in the analysis, that recognition be given at the end of the day to justifiable reliance interests and settled expectations. Whatever the theory, the Commonwealth does not understand the debate to question the correctness of the *results* in the cited cases. Just as in those cases, there are strong equitable considerations that should lead to a similar result in this case.

[8] These values are of importance both to the states as tax collectors and to taxpayers. As Allied-Signal, Inc. stated to this Court in April 1992:

> There is one proposition that both parties and all of the *amici* that address the question accept: that the test of *Chevron Oil Co. v. Huson*, 404 U.S. 97 (1971), should determine whether a decision overruling *ASARCO* and *Woolworth* is retroactive. This unanimity on the part of

Davis is that extraordinary case that imposes such a dramatic new liability. The decision of this Court three years ago in *Davis* generated litigation involving more than $1.8 billion in refund claims in at least 23 states.[9] Much of this litigation has yet to be resolved in the state courts, and five cases that originated in state courts are presently pending in this Court on petitions for certiorari.

In Virginia alone, the potential refund liability resulting from the *Davis* decision now exceeds $467 million. Joint Appendix ("JA") 24 . This Court can take judicial notice that this sum is larger than the entire annual budget for the Department of Corrections. It is also larger than the annual general fund appropriation for the three largest universities in the State. SA 2. Revenue losses to the State due to inflation, the condition of the economy, and an 18.4% increase in federally mandated Medicaid expenses have already required the reduction of state agency budgets on an average of 25% below 1990 funding levels, as well as the elimination of jobs through early retirement and layoffs. The losses that would

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> taxpayers and taxing officials – even those whose short-term interests in this case might be furthered by a rule of absolute retroactivity – is a powerful reminder that stability in the law is highly valued by all segments of society.

Reply Brief of Petitioner on Reargument at 15-16.

Likewise, the Tax Executives Institute (representing taxpayer interests) embraced the *Chevron Oil* test in its *Allied-Signal* amicus brief, and further argued at 17:

> The retroactive [application of a new rule] would also send an ominous signal to all taxpayers concerning their ability to rely on established rules. Not only would multijurisdictional taxpayers be exposed to unexpected and potentially enormous tax liabilities for all open tax years, but they would be deprived of the certainty necessary to conduct their business affairs in an orderly manner.

Chevron Oil provides a standard for protecting reliance interests and the orderly conduct of business in a manner that is equitable both to taxpayers and to states.

[9] Alabama, Arizona, Arkansas, Colorado, Georgia, Iowa, Kansas, Kentucky, Louisiana, Michigan, Mississippi, Missouri, Montana, New Mexico, New York, North Carolina, Oklahoma, Oregon, South Carolina, Utah, Virginia, West Virginia, and Wisconsin. *See* W. Hellerstein, *Preliminary Reflections on* McKesson *and* American Trucking Associations, 48 Tax Notes 325, 326 (1990).

result from the application of *Davis* to require refunds to these Petitioners and other similarly situated federal retirees can be recouped only by making further cuts in services or employment, or by enacting additional revenue measures. The amount of additional revenue required to offset this unexpected liability, should it materialize, is the equivalent of the income that would be realized in one year from a 22% increase in Virginia's sales tax from 4.5% to 5.5% or by imposing a 13.6% income tax surcharge on the 1991 returns of all citizens in the State. Surely there is room in legal doctrine to make the consideration of factors such as these relevant to the potential retroactive imposition of monetary liability for a newly announced principle of law.

C. Application of the *Chevron Oil* formula to *Davis* results in the conclusion that *Davis* should not be retroactively applied.

1. *Davis* established a new principle of law.

The first issue in the application of *Chevron Oil* to these facts is whether *Davis* announced a "new" rule of law. Expressed in the language of *Chevron Oil* itself, the question is whether *Davis* decided "an issue of first impression whose resolution was not clearly foreshadowed."[10] *Chevron Oil*, 404

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[10] Petitioners attempt arbitrarily to limit *Chevron Oil* to cases in which new law is established by the overruling of prior Supreme Court precedent. But this is inconsistent with the language of *Chevron Oil* itself, which explicitly described a "new principle of law" as one which "overrul[ed] clear past precedent on which litigants may have relied" *or* "decid[ed] an issue of first impression whose resolution was not clearly foreshadowed." *Chevron Oil*, 404 U.S. at 106. Indeed, *Chevron Oil* itself declined to apply retrospectively a decision that overruled no prior Supreme Court precedent. Moreover, as *Chevron Oil* itself recognizes, the effect on reliance interests and settled expectations can be the same when the Court decides an issue of first impression as when it overrules past precedent. This Court is unlikely ever to see a stronger case of reliance and settled expectations than here presented.

Petitioners also construct an argument, not presented in the court below, that *Chevron Oil* cannot apply in a case involving a federal statute. Unless *Davis* is fully retroactive, Petitioners assert, this Court will be usurping a legislative power by

U.S. at 106. Expressed in the related language of the principles undergirding *stare decisis*, the question is whether *Davis* upset "substantial reliance and expectations that had become part of a basic framework" of a state's authority to impose taxes. *Quill Corp.*, 112 S. Ct. at 1916.

(i) If *Davis* did not announce a new principle of law, why did Petitioners and other taxpayers like them pay the tax for nearly half a century without mounting any legal challenge?

This Court has observed that when a decision "disrupts a practice long accepted and widely relied upon,"[11] it constitutes a new rule of law. At the time of the *Davis* decision, a majority of the states that impose an earned income tax (23 out of 41) had statutes similar to the Michigan statute at issue in *Davis*. Many of these statutes, including Virginia's, had been in effect for nearly half a century. *See* Ch. 325, 1942 Va. Acts 500. Section 111 of Title 4 of the United States Code, on which so much reliance is placed by Petitioners, was enacted in 1939. Public Salary Tax Act of 1939, ch. 59, § 4, 53 Stat. 575, now codified at 4 U.S.C. § 111. The intergovernmental tax immunity doctrine had been around much longer. Yet federal pensioners living in these 23 states and their tax lawyers evidently found nothing in the language of § 111 or prior Court decisions which "foreshadowed" *Davis* sufficiently to provoke litigation. Before *Davis*, not one Virginia pensioner (including retired Internal Revenue Service officials and retired federal tax lawyers) sought through either judicial or administrative proceedings to have the tax declared

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determining the effective date of an Act of Congress. This argument is contrary to prior decisions of this Court, including *Chevron* itself which delayed the effect of a *federal* statute, 43 U.S.C. § 133(a)(2), which incorporated state statutes of limitations. *See also Florida v. Long*, 487 U.S. 223 (1988); *Northern Pipeline Construction Co. v. Marathon Pipe Line Co.*, 458 U.S. 50 (1982).

[11] *Milton v. Wainwright*, 407 U.S. 371, 381-82 n.2 (1972) (Stewart, J., dissenting), *quoted with approval* in *United States v. Johnson*, 457 U.S. 537, 552 (1982).

unconstitutional as violating § 111 or intergovernmental tax immunity.[12] What Petitioners portray as the application of settled law to an unambiguous statute was, in fact, entirely unpredicted for almost 50 years by 23 legislatures and by hundreds of thousands of taxpayers whose self-interest would have led them to object had they thought the tax problematical. The fact that this widespread tax policy had gone unchallenged for so many years, by either the United States or hundreds of thousands of federal retirees living in these 23 states, itself is compelling – indeed conclusive – evidence that *Davis* announced a new rule of law.

(ii) The only federal court to consider the issue held *Davis* not foreseeable.

Only one federal court has had the opportunity to address the foreseeability of *Davis*. *Swanson v. Powers*, 937 F.2d 965 (4th Cir. 1991), *cert. denied*, 112 S. Ct. 871 (1992) ("*Swanson*"). *Swanson* was a civil action filed under 42 U.S.C. § 1983 against the North Carolina Secretary of Revenue exposing her to a potential personal liability of $140 million for enforcing the North Carolina counterpart to the tax invalidated in *Davis*. In an opinion by Judge J. Harvie Wilkinson, the Fourth Circuit held Ms. Powers entitled to the defense of qualified immunity on the ground that the principles upon which *Davis* was based were "not clearly established at the time." 937 F.2d at 966. The plaintiffs argued in *Swanson*, as Petitioners argue here, that nothing "new" was established in *Davis*. Speaking for the court, Judge Wilkinson responded:

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[12] Until *Davis*, federal retirees in Virginia confined their objections to this tax to appeals to the political process. *See* Report of House Finance Retirement Subcommittee, Dec. 1982, cited in Brief Amicus Curiae on Behalf of Military Coalition in Support of Petitioners. There are no facts in the record nor any known to the Commonwealth which suggest that prior to *Davis*, the Virginia tax benefit to state retirees had been challenged as illegal (under § 111 or any other theory). Even in the legislative study focused on this particular tax there is no argument that the tax violated any law. It should be emphasized that the federal retirees were unsuccessful in persuading the legislature to change its tax policy, and they *still* made no effort to challenge the tax in a judicial or administrative forum until after this Court's decision in *Davis*.

> We disagree. Secretary Powers was enforcing a long-standing statute that was similar to enactments elsewhere. The most pertinent judicial decisions had upheld comparable taxing schemes and the doctrine of intergovernmental immunity was, at best, ambiguous. We decline to proclaim in hindsight after the *Davis* decision, that the unconstitutionality of differential tax exemptions had been clear all along.

937 F.2d at 968.

It is against the background of other "pertinent judicial decisions" that the Fourth Circuit reviewed *Davis*. In response to the argument – repeated here by Petitioners – that the doctrine of intergovernmental tax immunity is long-standing, hailing from the time of *McCulloch v. Maryland*, 17 U.S. (4 Wheat.) 316 (1819), Judge Wilkinson correctly observed that "the vintage of the asserted right is of less guidance than the specificity of the right." 937 F.2d at 969. Judge Wilkinson noted that, prior to *Davis*, no court had struck down tax exemptions similar to the one challenged in *Davis*. In fact, the only two state courts that had considered the exemption had upheld the statutes. *Davis v. Michigan Dep't of Treasury*, 160 Mich. App. 98, 408 N.W.2d 433 (1987); *Streight v. Ragland*, 280 Ark. 206, 655 S.W.2d 459 (1983).

The Fourth Circuit also reviewed a line of federal cases that establish the "modern approach to intergovernmental tax immunity." *See United States v. County of Fresno*, 429 U.S. 452 (1977); *United States v. City of Detroit*, 355 U.S. 466 (1958); *James v. Dravo Contracting Co.*, 302 U.S. 134 (1937). The court rejected the argument that these cases formed a basis for predicting that the tax exemption was unconstitutional. In fact, the court concluded, the cases viewed as a whole represent the Court's "shift in emphasis away from immunity from taxation and toward limitation of such immunity." 937 F.2d at 970. Narrowing its review finally to recent intergovernmental tax immunity decisions more specifically related to the facts in *Davis*, the court concluded that the rationale of these cases could reasonably lead to a

contrary result from that reached in *Davis*. *See South Carolina v. Baker*, 485 U.S. 505 (1988); *Washington v. United States*, 460 U.S. 536 (1983); *United States v. County of Fresno*, 429 U.S. 452 (1977). These cases were based on the rationale that states could not impose an unfair burden on the federal government by "singling out" federal interests for different treatment. In *Davis*, the tax was imposed not only on federal retirees but also on all private retirees, thus singling out retired state employees for an exemption but not singling out retired federal employees for a tax. *Swanson*, 937 F.2d at 970. It was this divergence in *Davis* from the rationale supporting other intergovernmental tax immunity doctrine decisions that the Fourth Circuit regarded as an important basis for its holding that *Davis* had not been "clear all along."[13]

(iii) *Davis* decided two issues of first impression whose resolution was not clearly foreshadowed by prior decisions.

We address in this section of the brief two of the fundamental respects in which *Davis* announced new principles of law. We do so not to reargue the merits of that decision, but to highlight the ways in which, in the language of *Chevron Oil*, the result reached was not clearly foreshadowed by prior decisions.

All tax classifications, of course, "discriminate" among groups and types of income. In general, as this Court noted in *Phillips Chemical Co. v. Dumas Independent School District*, 361 U.S. 376, 385 (1960) ("*Phillips Chemical*"), the state has

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[13] There is a difference between the issue in the present litigation and the issue in *Swanson*. Yet the cases governing when a qualified immunity can be asserted in a § 1983 suit have as one of their primary goals the avoidance of unfairly imposing retroactive monetary liability on state officials for failing to foresee the unforeseeable. The issue here is the same, albeit here the defendant is the state (or more realistically its taxpayers). The unconscionability of holding Ms. Powers personally liable for $140 million for failing to anticipate *Davis* strongly suggests that the general public should not suffer decreased public safety or education (or, conversely pay more taxes) in order to pay a retroactive damage award for the failure of the same public officials to foresee the unforeseeable.

broad discretion to make distinctions and classifications as long as there is a nonarbitrary, rational basis for what has been done: "[T]he State's power to classify is, indeed, extremely broad, and its discretion is limited only by constitutional rights and by the doctrine that a classification may not be palpably arbitrary." What Virginia and other states did not foresee, and had no reason to foresee, is that the tax exemption at issue in *Davis* constituted a discrimination against *federal government interests* and therefore implicated § 111 and the intergovernmental tax immunity doctrine. Below we show why this was so.

(1) *The Interpretation of Section 111.* The meaning of the Public Salary Tax Act of 1939, 4 U.S.C. § 111, had never been addressed by this Court prior to *Davis*. In that decision it was read for the first time as applying to former federal employees who were receiving retirement benefits.

Section 111 provides, in relevant part:

> The United States consents to the taxation of the pay or compensation for personal service as an officer or employee of the United States . . . by a duly constituted taxing authority having jurisdiction, if the taxation does not discriminate against the officer or employee because of the source of the pay or compensation.

The Michigan Supreme Court held this statute inapplicable to Mr. Davis because he was not then an employee of the United States and his retirement income accordingly was not compensation for services "as an . . . employee." This Court disagreed. While conceding that "Congress could perhaps have used more precise language," 489 U.S. at 810, and acknowledging that retirees are no longer "employees," this Court concluded that the pensions of federal retirees constituted compensation they received "as" federal employees with payment deferred until retirement.

As the Fourth Circuit concluded in *Swanson*, this reading was not clearly foreshadowed by prior decisions. The *Swanson* court, noting that "federal law often draws distinctions

between employees and retirees,"[14] concluded that "how the intergovernmental tax immunity doctrine and 4 U.S.C. § 111 applied to North Carolina's revenue statutes was *anything but* clearly established prior to *Davis*." 937 F.2d at 971 (emphasis added).

The only cases cited by this Court in support of its reading of § 111 were three federal circuit court opinions: *Zucker v. United States*, 758 F.2d 637 (Fed. Cir.), *cert. denied*, 474 U.S. 842 (1985); *Kizas v. Webster*, 707 F.2d 524 (D.C. Cir. 1983); and *Clark v. United States*, 691 F.2d 837 (7th Cir. 1982). It would have taken a truly heroic effort to read these three cases as presaging the conclusion reached by this Court in *Davis*.[15]

If anything, *Clark* suggests that the *Davis* tax was entirely appropriate. *Clark* rejected a claim by state and private pensioners who argued that they were being discriminated against when Congress provided a cost-of-living adjustment to federal pensioners but not to them. The court held that federal pensioners constituted a legitimate class of similarly situated persons (distinct from state and private pensioners) to whom "[t]he United States . . . has special responsibilities and obligations . . . that it does not have to non-federal employees." 691 F.2d at 841-42. Such special

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[14] The Court's illustrations of this point were *Allied Chemical Co. & Alkali Workers v. Pittsburgh Plate Glass Co.*, 404 U.S. 157, 165-71 (1971) ("employee" as used in National Labor Relations Act does not include "retirees"); *Ernzen v. United States*, 715 F.Supp. 1483, 1485 (S.D. Cal. 1989) ("[n]owhere does the [tax] code define 'retirees' as 'employees'"); 26 U.S.C. § 61(a)(1), (11) (Internal Revenue Code distinguishing between "compensation for services" and "pensions").

[15] The issue in *Zucker* was entirely unrelated to the issues in *Davis*. It was *argued* (for another purpose, under other statutory provisions) that federal retirement benefits were a form of deferred compensation, but the court explicitly did "not reach the question of the compensatory nature of the basic annuity to which the retiree became entitled upon retirement." 758 F.2d at 639. *Kizas* did not even involve federal retirees. It was a suit by clerical and support personnel of the FBI objecting to an affirmative action program adopted by the Bureau and to resulting changes in the "special preferences" under which they could make application to become Special Agents. *Clark* did discuss the pension benefits of federal employees, but it did not do so in the context of whether retirees received their benefits "as" employees under § 111.

treatment of federal retirees allowed the federal government to "compete with the private sector by offering federal employees an attractive retirement plan." *Id.* at 842. And the court said explicitly that "[a]ttracting and retaining qualified employees is a legitimate state objective that is rationally achieved by a retirement plan offering an economic inducement . . . ." *Id.* This rationale would appear fully to support the Michigan court's conclusions that Michigan was justified in making a tax distinction that benefitted its own pensioners.[16]

This Court's reading of § 111 may, in retrospect, seem perfectly logical, but the fact remains that from the enactment of the statute in 1939 until the decision in *Davis* 50 years later there were no decisions – by this Court or any other federal or state court – that had addressed the issue resolved in *Davis* or, indeed, any closely analogous issue from which the result in *Davis* could have been predicted.[17] The Virginia statute that was displaced by Davis was enacted in 1942, only three years after § 111 was enacted. To say now that the *Davis* interpretation of § 111 had so obviously been the law since 1939 that the Virginia legislature should have revised its tax policies for the years at issue in this case, even though no state, no taxpayer, and no court had occasion to recognize that fact during the preceding 45 years of the existence of the tax, would seem so plainly wrong as not to warrant comment were it not the heart of Petitioners' argument in this case.

(2) *Whether the tax discriminated against federal interests.* The determination that § 111 applied to the tax before the Court in *Davis* was only the first step in the analysis. Section 111 by its terms consents to the taxation of federal

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[16] There was surely nothing in *Clark* to suggest that an enhancement in the form of a cost-of-living increase was materially different from an enhancement in the form of a tax benefit. Nor was there anything to suggest that *Clark* was addressing a special privilege of the federal government that would not be equally available to the states.

[17] Prior to *Davis* there were only a handful of reported cases interpreting § 111, none of which forecasted the result in *Davis*. Most involved the question whether the consent to tax extended to territories and municipalities.

employees so long as the taxes do not "discriminate against the . . . employee because of the source of the pay or compensation." The critical question in *Davis*, therefore, was whether the Michigan tax worked such a discrimination. And this question, the Court held in *Davis*, was to be measured against the doctrine of intergovernmental tax immunity.

There are three steps in the resolution of any claim of unwarranted discrimination, whether it be under the equal protection clause or some other constitutional or statutory limitation. The first is to identify who it is that is being discriminated against and on what basis. The second is to determine the level of protection against discrimination to which that party is entitled, to choose the standard against which justifications for the discrimination are to be measured. The third is to assess any offered justifications for the discrimination against the chosen standard.

It is the first of these steps that was crucial in *Davis*. There were two ways to look at the classification adopted by the *Davis* tax that would have been relatively benign. One would have been to regard the state and local pensioners as being preferred to all other taxpayers in the state or, to turn the point around, to regard the tax benefit as discriminatory against all other taxpayers as an undifferentiated group.[18] Another (as in *Clark*) would have been to regard those who were receiving pensions from state or local government as being preferred to all other taxpayers who were receiving pensions (*i.e.*, those who were receiving pensions from the federal government and those who were receiving pensions from private sources).[19] In this case, the group that was being discriminated against would be federal pensioners and private pensioners as an undifferentiated group. Had the distinction drawn

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[18] In Michigan, there were 4½ million individual taxpayers and 130,000 retired state employees. If this were the proper frame of reference, the question would be whether some 24,000 federal retirees were being discriminated against by being grouped with the 4½ million rather than the 130,000.

[19] This would have been in accord with one of the prime rationales stated for § 111: the fairness of "subject[ing] the compensation of public officials and employees to the same general burden of taxation as is borne by *private employees*." S.Rep. 112 at 1, 76th Cong., 1st Sess. (1939) (emphasis added).

by the *Davis* statute been viewed in either of these manners, the conclusion easily could have been reached that there was no discrimination against the federal government or its employees. Former state employees were being favored, to be sure, but they were a small group being preferred to much larger classes of persons that included federal retirees but that also included many other taxpayers unconnected with the federal government.[20] It most likely would have followed, were this the proper perspective, that the tax in *Davis* would have been upheld.[21]

The Court's reasoning in *Davis* did not follow this path. Its premise was that the tax should be regarded as preferring those who were receiving pensions from the state to those who were receiving pensions from the federal government or, again to turn the point around, to regard the tax as discriminatory against federal interests. Once the distinction drawn by the tax was viewed in this light, the rest of the analysis was fairly straightforward. It followed that a higher standard of justification was required in order to sustain the tax (there must be "significant differences between the two classes" rather than merely a "rational basis" for the distinctions drawn) and, in turn, that the State's proffered justifications were insufficient to meet this elevated standard.

The relevant question now is not whether the Court was correct to regard the *Davis* tax as discriminatory against federal interests, but whether, as the *Swanson* court found, the Court's conclusion in this respect was unpredictable based on prior decisions. Was "new" law established in the judgment that the *Davis* tax discriminated against federal pensioners?

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[20] There are approximately 3½ million individual taxpayers in Virginia. The number of federal retirees is estimated at 200,000. There are approximately 60,000 state and local retirees (some of whom live outside Virginia), and there are somewhat over 200,000 private retirees. See JA 25.

[21] It seems clear that if the traditional equal protection "rational basis" test were the correct standard against which to measure the Michigan tax, it would have survived. *See Lehnhausen v. Lake Shore Auto Parts Co.*, 410 U.S. 356 (1973). It is likely that the tax would have survived this inquiry for the same reasons the federal government was allowed to give its retirees monetary benefits denied to state and private retirees in *Clark v. United States*, 691 F.2d 837 (7th Cir. 1982).

Close examination of this Court's opinion reveals that it was. The issue of discrimination is addressed in two places in the opinion. The first is a one-sentence assertion, without further elaboration or citation of authority: "It is undisputed that Michigan's tax system discriminates in favor of retired state employees and against retired federal employees." *Davis*, 489 U.S. at 814. The second is in the Court's answer in footnote 4 to Justice Stevens' dissent.[22]

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[22] That footnote reads in full:

> The dissent argues that this tax is nondiscriminatory, and thus constitutional, because it "draws no distinction between the federal employees or retirees and the vast majority of voters in the State." *Post*, at 823. In *Phillips Chemical Co.*, however, we faced that precise situation: an equal tax burden was imposed on lessees of private, tax-exempt property and lessees of federal property, while lessees of state property paid a lesser tax, or in some circumstances none at all. Although we concluded that "[u]nder these circumstances, there appears to be no discrimination between the Government's lessees and lessees of private property," 361 U.S., at 381, we nonetheless invalidated the State's tax. This result is consistent with the underlying rationale for the doctrine of intergovernmental tax immunity. The danger that a State is engaging in impermissible discrimination against the Federal Government is greatest when the State acts to benefit itself and those in privity with it. As we observed in *Phillips Chemical Co.*, "it does not seem too much to require that the State treat those who deal with the Government as well as it treats those with whom it deals itself." *Id.*, at 385.
>
> We also take issue with the dissent's assertion that "it is peculiarly inappropriate to focus solely on the treatment of state governmental employees" because "[t]he State may always compensate in pay or salary for what it assesses in taxes." *Post*, at 824. In order to provide the same after-tax benefits to all retired state employees by means of increased salaries or benefits payments instead of a tax exemption, the State would have to increase its outlays by more than the cost of the current tax exemption, since the increased payments to retirees would result in higher federal income tax payments in some circumstances. This fact serves to illustrate the impact on the Federal Government of the State's discriminatory tax exemption for state retirees. Taxes enacted to reduce the State's employment costs at the

Except for the reference to *Phillips Chemical* in footnote 4, no previous decisions by this Court or any other federal or state court are mentioned to support the conclusion that the tax in *Davis* worked a discrimination against the federal government or federal retirees.[23] The question arises, therefore, whether *Phillips Chemical* clearly foreshadowed the *Davis* decision within the meaning of *Chevron Oil*. The view that it did, we observe at the outset, must confront the fact that it was not until 1989 that it was discovered that this 1960 decision had an impact on the validity of a tax that had been in effect in almost half the states since at least 1942. That 29 years passed between *Phillips Chemical* and *Davis* (and that it did not occur to any taxpayer, tax attorney, state or federal court, or law review author that the *Davis* tax might be troublesome) is powerful testimony that it was far from obvious that *Phillips Chemical* led inexorably to the demise of the *Davis* tax.

Moreover, a careful reading of *Phillips Chemical* makes it understandable why no such conclusions were drawn. That case involved local property taxes on leasehold interests. Those who leased land from the owners of private property were not taxed.[24] Those who leased land from a private tax-exempt organization (a church or a charity) likewise were not taxed.[25] Those who, like Phillips Chemical Co., leased land

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> expense of the federal treasury are the type of discriminatory legislation that the doctrine of intergovernmental tax immunity is intended to bar.

489 U.S. at 815 n.4.

[23] There are likewise no prior cases predicting the Court's answer to the argument discussed in the second paragraph of footnote 4 in *Davis*. It will be noted that no cases or other prior authorities are cited for the Court's assertions in that paragraph. Moreover, had the state chosen to provide its retirees higher benefits rather than a tax exemption, the state tax paid on those benefits would have been deductible on the retirees' federal income tax returns. It is far from clear that there would have been any impact on the federal fisc had the state chosen this option rather than the tax exemption.

[24] Taxes in that instance were assessed against the owner-lessor.

[25] In this instance, the tax exemption did not survive the lease, and the owner-lessor again paid the tax.

from the federal government were taxed under Article 5248, which applied directly and explicitly to land "held, owned, used, and occupied by the United States." Those who leased land from the state or local governments were taxed under the different and less onerous provisions of Article 7173. Indeed, because of certain exemptions in Article 7173, Phillips Chemical Co. would have paid no tax if it had an identical lease from the state or local government. In this setting, the Court held that the tax under Article 5248 discriminated against the United States:

> [A]ll lessees of exempt public lands would appear to belong to the class defined by Article 7173. In view of the fact that lessees in this class are taxed because they use exempt property for a nonexempt purpose, they appear to be similarly situated and presumably should be taxed alike. Yet by the amendment of Article 5248, the Texas Legislature *segregated federal lessees* and *imposed on them a heavier tax burden* than is imposed on the other members of the class by Article 7173. . . . The discrimination against the United States and its lessee seems apparent.

361 U.S. at 381-82 (emphasis added). Once the Court had determined that the tax discriminated against the federal government, it followed that a higher than normal standard would govern the acceptability of the state's proffered justifications for the tax (there must be "significant differences" between federal lessees and state or local lessees rather than a "rational basis" for treating them differently). It also followed that the state's justifications did not measure up to this elevated standard.

Why did the Court in *Phillips Chemical* take the critical first step of concluding that the Texas tax discriminated against federal government interests? As appears from the quotation immediately above, the reason was that the tax statute on its face created a class of taxpayers that consisted of two (and only two) groups: (1) lessees from the federal government and (2) lessees from state or local government. Since these were the only two groups being taxed, and since both involved "use [of] exempt property for a nonexempt purpose, they appear(ed) to be similarly situated and

presumably should [have] be[en] taxed alike." Since a higher tax was imposed on federal lessees (and since the higher tax obviously made the federal government a less attractive landlord), "[t]he discrimination against the United States and its lessee seems apparent."[26]

The Court did note that "there appears to be no discrimination between the Government's lessee and lessees of private property." 361 U.S. at 381. It apparently reached this conclusion on the assumption that the full value of the taxes would be passed on to private lessees in their rents.[27] But this observation does not diminish the fact that the tax at issue in *Phillips Chemical* singled out federal government interests for the imposition of a special tax that was not imposed on anyone else and that reasonably could have been expected to affect the leasing operations of the federal government.[28] The *Davis* tax did not do this: it exempted retired

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[26] As Justice Stevens pointed out in his dissent in *Davis*, *Phillips Chemical* would have been on all fours with the *Davis* situation "if Michigan's income tax applied only to public employees; on that hypothesis, if state employees were exempted, the tax would obviously discriminate against federal employees." 489 U.S. at 825 (Stevens, J., dissenting).

[27] On this point the Court said: "The full value of the leased property becomes taxable to the owner, and the lessee's indirect burden consequently is as heavy as the burden imposed directly on federal lessees by Article 5248." 361 U.S. at 380-81.

This conclusion is surely plausible, but was not supported by the record and is not necessarily correct. It will not always be the case that leasehold rents will reflect property taxes on a dollar-for-dollar basis; other economic factors can easily intrude to push rents up or down independently of tax increases or savings. The Court in *Phillips Chemical* did not have occasion carefully to examine this point because the tax at issue was not defended on the ground that the federal government was not being discriminated against. The defense to the tax, by contrast, was that the differential treatment was justified.

[28] Historically, the intergovernmental tax immunity doctrine has restricted states from enacting taxes that "impede" the federal government in the "execution of [its] powers." *McCulloch v. Maryland*, 17 U.S. (4 Wheat.) 316, 436 (1819). See also the House Report's explanation of the "discrimination" language in § 111: "To protect the Federal Government against the unlikely possibility of State and local taxation which is aimed at, or threatens the efficient operation of, the Federal Government, the consent is expressly confined to taxation which does not discriminate against such officer or employee because of the source of the compensation."

state employees from a tax that by its terms was imposed on all other citizens with reportable income. Federal government interests were not singled out for special or differential treatment. And it was far from apparent that such a tax could have a detrimental effect on any operations of the federal government.

The Commonwealth knew that a tax that segregated federal interests for more burdensome treatment than imposed on other taxpayers would be difficult to justify under the doctrine of intergovernmental tax immunity. What the Commonwealth did not understand until *Davis* was that the tax at issue here would implicate the same concerns.[29] Unlike in *Phillips Chemical*, no special statute imposed a tax on retired federal employees. They were treated in Virginia just like all retirees from private employment, and indeed just like all employed taxpayers. Virginia did make special provisions for its own retired employees, and it chose to do so in the form of a tax exemption rather than a cash payment. Had it made a cash payment instead, it is inconceivable that there would have been any basis for objection because it did not also make a cash payment to retired federal employees. It seemed to any careful tax lawyer or state official to make no difference that a tax exemption was the form in which Virginia dispensed a

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H.Rep. No. 26 at 5, 76th Cong., 1st Sess. (1939). And see *United States v. City of Manassas*, 830 F.2d 530 (4th Cir. 1987), *aff'd*, 485 U.S. 1017 (1988). In that case, as in *Phillips Chemical*, a local tax was struck down that singled out federal interests for the imposition of a tax that was not imposed on non-governmental entities, that exempted certain state interests from payment of the tax, and that directly affected the cost of services supplied to the United States. The fact of discrimination was taken as given, and the focus was on whether the differential treatment could be justified. Neither *Phillips Chemical* nor *Manassas* provided any guidance on the issue in *Davis* that is critical now, namely, how the Michigan tax could be held to discriminate against federal interests.

[29] The principle that state taxes could not discriminate against federal interests was, of course, well established prior to *Davis*. Petitioners and some of the amici think this sufficient to warrant the conclusion that no "new" principle of law was established by *Davis*. E.g., Pet. Br. at 11 n.6. But the longevity of the principle does not mean that all of its applications are clearly forecasted. The issue here is how predictable it was prior to *Davis* that the Michigan tax offended that principle. The resolution of that question, as Petitioners' own failure to challenge the tax prior to *Davis* so eloquently demonstrates, is what was "new" about *Davis*.

fringe benefit to its own employees. The holding in *Davis* was that the form of the fringe benefit made a fatal difference. But so far as the *Davis* opinion and the Commonwealth's independent research reveal, there is no basis in prior decisions for one to have foreseen that the Court would conclude that the Michigan tax discriminated against retired federal employees.

2. Retroactive application of *Davis* would not further the operation of its rule.

Under the second *Chevron Oil* factor, the Court is to "weigh the merits and demerits in each case by looking to the prior history of the rule in question, its purpose and effect, and whether retrospective operation will further or retard its operation." 404 U.S. at 106-107, *quoting Linkletter v. Walker*, 381 U.S. 618, 629 (1965). It is clear that retroactive application is not necessary to "further" the rule announced in *Davis*. The Virginia General Assembly met in Special Session shortly after the March 28, 1989, decision in *Davis* and repealed the full subtraction for state and local government retirement benefits, effective retroactively to January 1, 1989, replacing it with a partial subtraction for all retirees. At no time after the *Davis* decision have the pension benefits of state and local government retirees been treated differently from the pension benefits of federal government retirees. The requirements of *Davis* have been met.

Petitioners argue that various compensatory and deterrence interests will be "furthered" by requiring Virginia to refund taxes which it had no reason to know were not validly assessed. Petitioners begin by asserting that taxpayers have legitimate compensatory interests safeguarded by the Supremacy Clause. Pet. Br. at 32-33. But, to the contrary, there is substantial doubt whether Petitioners have any compensatory interest at all.[30] The purpose of § 111 is not to prohibit

[30] Petitioners claim that "the revenue generated by the excessive taxes imposed on petitioners should have been raised by a nondiscriminatory tax on the population as a whole." Pet. Br. at 35. If the taxes foregone by the exemption of the modest state retirement income of some 50,000 retirees had been raised by a tax on the population as a whole, the corresponding reduction in Petitioners' tax liability for the years 1984 through 1989 would clearly have been minuscule. In 1982, the average Virginia federal civil retiree income was $15,416, while the average state retiree received $4,020 annually. *See* SA 20 (Comparative chart attached to Report of the House Finance Retirement Subcommittee, Dec. 1982, cited in Brief Amicus Curiae on Behalf of the Military Coalition in Support of Petitioners).

taxation but to permit taxation.[31] These taxpayers have no constitutional or federal statutory right to a tax *exemption*. The constitutional right they assert is not a traditional personal right, such as freedom of speech or religion or the freedom from illegal searches and seizures. It is not even about the freedom to be able to compete in interstate commerce. In fact, this case is not even about discrimination in any ordinary sense. This case is about intergovernmental relations, about the relationship between state and federal government. As the Court in *Davis* states, "intergovernmental tax immunity is based on the need to protect each sovereign's governmental operations from undue interference by the other." 489 U. S. at 814. It would retard rather than further this interest for this Court to require a state to redistribute huge sums of public moneys to a group of taxpayers who have suffered no harm to a right that is personal to them.[32]

[31] *See* H. Rep. 26 at 5, 76th Cong., 1st Sess. (1939) ("In order to *facilitate reciprocal taxation* as between State and Federal Governments, your committee believes that the United States should expressly consent to the taxation of the compensation of its officers and employees." (Emphasis added.))

[32] Any argument that the payment of refunds to Petitioners will in some way benefit the federal government by recompensing the federal fisc is speculative and plainly irrelevant. Moreover, there is no support for the view that the purpose of § 111 was to increase revenues in the federal fisc. Under § 111 and Davis states could validly choose not to exempt either federal or state retirement income. This approach would *reduce* federal tax revenues in that both federal and state retirees would then have state tax liabilities to deduct in calculating their federal tax liability.

It also cannot be convincingly argued that the federal government or its employees have unfairly subsidized state employment costs. Virginia's employment costs would not have been higher had it chosen, in the language of *Davis*, "to provide the same after-tax benefits to all retired state employees by means of increased salaries or benefits instead of a tax exemption." 489 U.S. at 803 n.4. The citizens of a state receive the benefit of the services provided by state employees

The argument that retroactive application of *Davis* is necessary as a punitive remedy against the Commonwealth to deter future invalid tax statutes is not only totally without merit but also is, under the facts of this case, unfair to the Commonwealth and its citizens. The tax exemption challenged here was enacted in 1942. No intervening events gave fair warning that the tax was inconsistent with federal law. Immediately after *Davis*, the legislature amended the statute in a manner that fully complies with the *Davis* holding. The court below specifically found: "[N]othing in the record suggests that the Commonwealth acted other than in good faith reliance upon a presumptively valid taxing statute." *Harper I*, 241 Va. at 236, 401 S.E.2d at 871 (SA 7). There is nothing in these facts for which the state, its legislature and its citizens should be "punished."

The argument that punitive remedies against a state are necessary to deter future invalid tax statutes was also made in *ATA v. Smith*: "Petitioners argue that the retroactive application of *Scheiner* will tend to deter future free trade violations which the several States have strong parochial incentive to commit." 496 U.S. at 181. The plurality rejected this argument in one sentence: "As we have just discussed, however, the . . . tax was entirely consistent with [prior law] and it is not the purpose of the Commerce Clause to prevent legitimate state taxation of interstate commerce." *Id.* Here, too, it is not the purpose of the Supremacy Clause or the doctrine of intergovernmental tax immunity to punish state actions taken in good faith. This Court has held in other contexts that prospective relief alone is sufficient to protect federal supremacy interests. *See Green v. Mansour*, 474 U.S. 64, 68 (1985) (holding that state had no obligation to provide retroactive monetary relief for wrongfully withheld welfare payments). The purpose of the intergovernmental tax immunity

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and pay for those services in one way or another. Moreover, since there were only 51,344 state retirees in Virginia in 1987, and a total of 2.56 million tax returns, JA 25, the state income tax foregone by the exemption represents a *de minimis* "subsidy" to employment costs by other citizens of the state.

doctrine likewise will be fully served if *Davis* is given only prospective effect.

3. Retroactive application of *Davis* in this case would result in inequity, injustice, and hardship to the citizens of the Commonwealth.

The third *Chevron Oil* factor requires a court to consider the inequity, injustice, and hardship imposed by retroactive application of a new judicial decision. *Chevron Oil*, 404 U.S. at 107. There can be no dispute that the imposition of a refund liability on the Commonwealth in an amount approaching $500 million will result in extreme hardship to the Commonwealth and its citizens. *See, e.g.*, JA 30-31, 33, 37-38, 41-43, 46. Virginia citizens will be affected by some combination of an increase in taxes at a time when few can afford it[33] or a reduction in services at a time when services are already being cut by current economic necessities.[34] Those who will suffer the most will be those who are the least able fully to provide for their own needs.

This Court has previously recognized the fiscal realities confronting state governments compelled to cope with massive budget deficits and adversely changing economies. Pointing to these considerations, Justice Powell, writing for five Justices in *Arizona Governing Committee for Tax Deferred Annuity and Deferred Compensation Plans v. Norris*, 463 U.S. 1073 (1983), concluded that the imposition of retroactive monetary liability amounting potentially to hundreds of millions of dollars against the state of Arizona would be inappropriate even though the state was found to have violated Title VII in its administration of a state retirement plan. He

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[33] The estimated liability in Virginia is the rough equivalent of 22% increase in the state sales tax (from 4.5% to 5.5%) or a surcharge of 13.6% on top of the state income tax owed by each and every individual taxpayer in Virginia. SA 3.

[34] State agency budgets have already been reduced for other reasons to a level that is 25% below 1990 funding levels, and state jobs have been eliminated through early retirements and layoffs. SA 3.

recognized that "[i]mposing such unanticipated financial burdens would come at a time when many state and local governments are struggling to meet substantial financial deficits," *id.* at 1106-07, and concluded that because the legality of Arizona's conduct had not been settled until the *Norris* decision, there was "no justification . . . to impose this magnitude of burden retroactively on the public." *Id.* at 1107. Similarly, in *Los Angeles Department of Water and Power v. Manhart*, 435 U.S. 702 (1978), in a holding from which, on this point, only Justice Marshall dissented, the Court concluded that, despite the presumption in favor of retroactive relief for a violation of Title VII, the granting of retroactive relief by the lower court was in error. Justice Stevens stated for the Court:

> There can be no doubt that the prohibition against sex-differentiated employee contributions represents a marked departure from past practice. Although Title VII was enacted in 1964, this is apparently the first litigation challenging contribution differences based on valid actuarial tables. Retroactive liability could be devastating for a pension fund. The harm would fall in large part on innocent third parties.

435 U.S. at 722-23.[35]

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[35] *See also City of Newport v. Fact Concerts, Inc.*, 453 U.S. 247, 267 (1981) (when liability is imposed on a government, the ultimate burden falls not on the "government," but on "the shoulders of blameless or unknowing taxpayers"); *Edelman v. Jordan*, 415 U.S. 651 (1974). There is no general principle of federal law that government should always shoulder the burden of retroactive relief to all plaintiffs for all kinds of injuries in all contexts. Petitioners' reference to *Owen v. City of Independence*, 445 U.S. 622 (1980), is simply irrelevant. Pet. Br. at 22. The issue presented in *Owen* was whether local government officials were entitled to a form of the qualified immunity defense afforded to many § 1983 defendants. It does not stand for the proposition that government is always retroactively liable in compensatory damages for unforeseen changes in the law, nor does any other case ever decided by this Court. Rather, it implements the particular compensatory policies reflected in a federal statute the very purpose of which is to provide remedies for certain constitutional violations and that explicitly does not include liability imposed on the state itself. *See Will v. Michigan Dep't of State Police*, 491 U.S. 58 (1989). Eight Justices in *ATA v. Smith* rejected the argument that *Owen* holds that constitutional decisions always apply retroactively against the government. 496 U.S. at 184, 216 n. 5.

The argument that fairness requires that Petitioners, who claim to "have paid more than their fair share" of taxes, Pet. Br. at 35, should be reimbursed is illogical. It is not just the state and local government retirees, the only group that has been paying less than all other recipients of retirement income, who will be required to pay any refunds. The refund liability will fall on all taxpayers of the Commonwealth, including not only Petitioners but also hundreds of thousands of private pension recipients who have no claim for monetary relief whatsoever. It is unfair to the citizens of the Commonwealth to impose on them retrospective monetary liability because a small group of some 50,000 civil servants benefited from a state income tax subtraction that had been in effect for half a century and that was declared illegal based on an unforeseeable development in the law. There is no justice or equity in such a result.

Petitioners contend that the Commonwealth's equitable argument is weakened by the decision of the General Assembly to extend a tax exemption to federal and private retirees rather than to terminate the exemption for state retirees. Pet. Br. at 36 n.23. Further, Petitioners argue, the Commonwealth could have limited its exposure to refund liability by not adopting a special statute of limitations expanding the period for federal retirees to file claims for refunds. Pet. Br. at 37.

Ironically, Petitioners assert that because the Commonwealth acted in a fair and equitable manner, it cannot now assert an equitable argument.

It is indeed true that the Commonwealth could have removed all exemptions for retirement benefits, including those of its civil servants who had relied on the exemption. But it could do so only by walking away from a long-standing covenant with state employees and retirees. The Commonwealth chose instead to honor its commitment to its employees and retirees. It would turn equity on its head to hold that because the Commonwealth acted out of a duty of fairness to its civil servants it cannot now be heard to argue that the rest of its citizens deserve to be treated fairly as well.

It is also true that the Commonwealth need not have extended the statute of limitations for federal retirees. The

Commonwealth could have required all federal retirees to retain accountants and to file amended returns or to hire attorneys and rush to the courthouse to preserve their claims, despite the fact that such actions would be of no benefit to the retirees absent a final court ruling that refunds were mandated. But, again, this choice would not be consistent with the Commonwealth's notions of fairness to its citizens. Virginia chose not to act punitively or restrictively toward its federal retirees, even in the face of claims of potentially crippling liability and even in the face of its resolution to oppose the claims on the merits.

The actions of the General Assembly following *Davis* are indisputable examples of the fair manner in which the Commonwealth deals with its taxpayers. To argue that the Commonwealth should now be punished for these actions can only be viewed by this Court as absurd.

There can be no question where the equities lie in this case. This is not a case of intentional government overreaching or impropriety. This is not a case where personal constitutional rights have been infringed by the inattention of government officials to fundamental constitutional principles. This is a case where an abstract principle of intergovernmental tax immunity was interpreted by the Court in an entirely unanticipated manner to strike down a tax policy employed by the Commonwealth and 22 other states in good faith for almost 50 years. These Petitioners could have objected to the Virginia tax before they paid it. They, or others like them, could have objected at any point over the past 50 years. One suspects that the reason they did not do so is that they did not realize, any more than did the Commonwealth, that the taxes offended federal law. The indignation with which they now assert their newly discovered claim is, when stripped of its rhetoric, an argument that they should receive an unanticipated windfall that would impose significant and hurtful consequences on their fellow taxpaying citizens in the communities where they live. The principles of federal law on which the *Davis* decision rests are fully satisfied, fully implemented, and fully respected by the prospective relief from

differential tax treatment which these Petitioners have already received. They are entitled to no more.

II. There is no requirement in federal law that Petitioners be afforded a retrospective refund remedy for taxable years concluded before *Davis*.

If *Chevron Oil* leads to the conclusion, as it should, that *Davis* is not to be retroactively applied to these Petitioners, this case is at an end. The Virginia Supreme Court decision must then be affirmed. But if this Court should decide that *Davis* did create retrospective rights in these Petitioners, two further issues remain.

The first is purely a question of state law. This Court's decisions establish that the scope of the available remedies in a case such as the present one is initially to be determined by reference to state law. *See Beam*, 111 S. Ct. at 2443; *McKesson*, 496 U.S. at 32 n. 16; *ATA v. Smith*, 496 U.S. at 176. In this case, the Virginia Supreme Court held, for reasons that have not been challenged by Petitioners as inadequate or not independent of federal law, that no state remedy is available. This conclusion is based, as discussed below, on state-court decisions that long pre-date the *Davis* litigation.

This resolution of the state law issue gives rise to a second question, namely whether federal due process limitations are offended by the unavailability of retrospective refund relief under state law. For two independent reasons discussed below, it is clear that due process does not require that Petitioners be afforded a remedy in this case. The first is that equitable considerations may appropriately be considered to foreclose the necessity of retrospective relief on facts such as these. The prospective relief already obtained by Petitioners is a fully adequate recognition of their federal rights. The second has to do with the timing of remedies available under state law. *McKesson* held that post-payment relief is required only if the state compelled the taxpayer to pay first and protest later. Under Virginia law, in contrast, all taxpayers are given an opportunity to obtain pre-payment relief. The availability of such relief, and the failure of these Petitioners

to seek it, forecloses any claim they would now make that federal law requires an additional, retrospective refund remedy when that relief is not available under clearly established state law.[36]

A. There is no retrospective refund remedy now available to Petitioners under state law.

In Part I of its opinion in *Harper I*, the Virginia Supreme Court addressed the *Chevron Oil* issues presented by this case. It then turned in Part II to a discussion of remedial issues. Petitioners had argued that they were entitled to a remedy under state law even if it were determined that *Davis* did not apply retroactively. The court first rejected that argument: "[B]ecause the *Davis* decision is not to be applied retroactively, the pre-*Davis* assessments were neither erroneous nor improper within the meaning of Code § 58.1-1826."[37] 241 Va. at 241, 401 S.E.2d at 873 (SA 12).

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[36] It follows from this discussion, indeed, that Part II of the decision in *Harper I* constitutes an adequate and independent state ground of decision that could foreclose the necessity of resolving the retroactivity issue raised by Petitioners.

[37] Section 58.1-1826 provides in full as follows:

> If the court is satisfied that the applicant is erroneously or improperly assessed with any taxes, the court may order that the assessment be corrected. If the assessment exceeds the proper amount, the court may order that the applicant be exonerated from the payment of so much as is erroneously or improperly changed, if not already paid and, if paid, that it be refunded to him. If the assessment is less than the proper amount, the court shall order that the applicant pay the proper taxes and to this end the court shall be clothed with all the powers and duties of the authority which made the assessment complained of as of the time when such assessment was made and all the powers and duties conferred by law upon such authority between the time such assessment was made and the time such application is heard. The court may order that any amount which has been improperly collected be refunded to such applicant. A copy of any order made under this section or § 58.1-1827 correcting an erroneous or improper assessment shall be certified by the clerk of the court to the Tax Commissioner.

The court then advanced an independent ground for the conclusion that Petitioners were not entitled to the remedy they were seeking:

> Harper's state-law contention also fails for another reason. We previously have held that this Court's ruling declaring a taxing scheme unconstitutional is to be applied prospectively only. *Perkins v. Albemarle*, 214 Va. 240, 198 S.E.2d 626, *aff'd and modified on rehearing*, 214 Va. 416, 200 S.E.2d 566 (1973). We adhere to our holding in *Perkins*. In so doing, we follow the criteria stated in *Fountain v. Fountain*, 214 Va. 347, 348, 200 S.E.2d 513, 514 (1973), *cert. denied*, 416 U.S. 939 (1974), that "consideration should be given to the purpose of the new rule, the extent of the reliance on the old rule, and the effect on the administration of justice of a retroactive application of the new rule." *See also Quick v. Harris*, 214 Va. 632, 634, 202 S.E.2d 869, 871 (1974), *cert. denied*, 420 U.S. 907 (1975).

241 Va. at 241-42, 401 S.E.2d at 873-74 (SA 12-13) (footnote omitted[38]).

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[38] The omitted footnote followed the citation to *Perkins* in the above quotation. That footnote read:

> The case of *Capehart v. City of Chesapeake*, No. 5459 (Circuit Court, City of Chesapeake, decided Oct. 16, 1974), followed *Perkins*. In *Capehart*, more than one hundred taxpayers in the City of Chesapeake, who had been subjected to the same practice that was invalidated in *Perkins*, brought suit in circuit court seeking, among other things, refunds on the taxes "illegally and unconstitutionally assessed." The City demurred, citing *Perkins*. The circuit court sustained the demurrer, being of opinion that the case was controlled by *Perkins*. We denied Capehart's petition for appeal, 215 Va. xlvii, and Capehart's petition for certiorari rasing due process grounds was denied by the Supreme Court, 423 U.S. 875, 96 S.Ct. 148, 46 L.Ed.2d 109 (1975).

241 Va. at 241 n. 3, 401 S.E.2d at 874 n.3 (SA 12-13). Under Virginia practice, the denial of a petition for appeal is a decision on the merits. *See Sutherland v. Swannanoa Corp.*, 189 Va. 149, 52 S.E.2d 92 (1949).

Perkins and *Capehart* interpreted an earlier and similarly worded refund statute for local tax assessments[39] not to require refunds in cases where settled expectations were upset by a ruling that a tax was unconstitutional.[40] In *Harper I*, which was reaffirmed by the court "in all respects" in *Harper II*, the Virginia Supreme Court held that state law does not entitle Petitioners to a refund of the challenged taxes for the same reasons the *Perkins/Capehart* plaintiffs were not entitled to retroactive refunds in 1973. It was thus a well-settled feature of Virginia law that equitable considerations were to determine the retrospective reach of decisions holding tax statutes unconstitutional.[41] Taxpayers were (and are) entitled under state law only to prospective relief.[42]

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[39] Va. Code § 58-1148 (Repl. Vol. 1969) (currently § 58.1-3987) stated, in relevant part: "If the court be satisfied from the evidence that the assessment is erroneous . . . the court may order that the assessment be corrected. If, in the opinion of the court, the assessment exceeds the proper amount, the court may reduce the assessment to what in its opinion based on the evidence is the fair market value of the property involved and shall order that the applicant be exonerated from the payment of so much as is erroneously charged, if not already paid and, if paid, that it be refunded to him."

[40] Under Virginia law, a Supreme Court interpretation of statutory language is deemed to be acquiesced in by the legislature if not overturned by subsequent legislation. *See, e.g., Burns v. Stafford County*, 227 Va. 354, 360, 315 S.E. 2d 856, 860 (1984).

[41] It should be noted that at no point in *Perkins*, *Capehart*, or its discussion of these cases in *Harper I* or *Harper II* did the Virginia Supreme Court cite any federal cases or make any reference to federal law. This case thus does not present the problem before the Court in *Michigan v. Long*, 463 U.S. 1032 (1983), of whether the state court decision was "independent" of federal law. It will also be noticed, moreover, that *Perkins* and *Capehart* were decided long before the *Davis* controversy arose.

[42] In their present brief on the merits filed in this Court, Petitioners assert for the first time that if they are not entitled to relief under state law, they are entitled to relief under the United States Constitution. Pet. Br. at 40. Even if this argument had any validity – a question that presents substantial difficulties of its own, *see Schweiker v. Chilicky*, 487 U.S. 412 (1988) – it comes too late. Petitioners' sole claim for relief in the courts below was based on Va. Code § 58.1-1826. JA 5-21. Petitioners have never asserted a claim for relief under the federal Constitution and it is far too late for them to do so now.

B. Federal due process concerns are not offended by limiting the state remedy to prospective relief.

Petitioners raise in this Court a Fourteenth Amendment due process argument that appears neither in their complaints (JA 5-21) nor their assignments of error to the Virginia Supreme Court below (JA 69). Petitioners argue that, if *Davis* is retroactive under federal law, the failure of the State to supply a retrospective refund remedy would violate due process principles enunciated in *McKesson*. Because this argument was not properly before the Virginia Supreme Court and was not addressed by that court, it is too late to raise it now.[43] The argument fails on the merits in any event because Virginia's tax refund statutes and procedures, including the limitation on refunds invoked in this case, fully satisfy the federal constitutional demands of due process.

(1) *Petitioners misconstrue* McKesson. Petitioners misread *McKesson* when they argue that that case requires a retrospective remedy here. The Florida tax at issue in *McKesson* post-dated the ruling of the Supreme Court in *Bacchus Imports, Ltd. v. Dias*, 468 U.S. 264 (1984), which declared a liquor tax in Hawaii unconstitutional under the Commerce Clause. Florida's previous tax system had been essentially the same as the system invalidated in *Bacchus*. Florida then amended its law in response to *Bacchus*, and it was this amended statute that was held unconstitutional by the Florida courts because it did not comply with the mandate of *Bacchus*.[44] The taxpayers sought the refund of taxes paid under the amended, but virtually identical, statute. It is important to note that they sought no refunds for taxes paid *prior* to *Bacchus*.

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[43] Under Virginia law, the Supreme Court can only consider such errors as are presented to it by appropriate assignments of error. *Wash v. Holland*, 166 Va. 45, 183 S.E. 236 (1936).

[44] This Court referred to the changes adopted in response to *Bacchus* as "only cosmetic." *McKesson*, 496 U.S. at 46.

In the case now before this Court, the Commonwealth promptly called a Special Session of its legislature and amended its tax system in response to *Davis*. Unlike *McKesson*, no challenge to the constitutionality of the amended statute has been or could be made here. Rather, Petitioners seek the refund of taxes paid under the statute now repealed, thus seeking the refund *only* of taxes for liabilities established *prior* to *Davis*,[45] taxes imposed before the Commonwealth had any notice that the taxes were subject to challenge.

McKesson establishes that, absent a predeprivation remedy, prospective-only relief is inadequate where it is entirely foreseeable at the time of enactment that a tax will be contested and likely invalidated. Fundamental fairness dictates that a state may not enact a tax statute which it knows or should know is unconstitutional, require that taxpayers pay the tax until the statute is invalidated by the highest court, and then deny the taxpayers any remedy for the period the statute was in effect.[46] Such a result violates fundamental fairness and properly destroys any equitable justification for denying retrospective relief. *McKesson*, 496 U.S. at 44-46.

It does not follow in all cases where state tax statutes are held in conflict with federal law, however, that a state may not consider equitable factors in determining whether retrospective relief is necessary or appropriate. In *McKesson*, the state presented various equitable arguments to justify the denial of retrospective relief, including the state's ability to engage in sound fiscal planning. The Court did not hold that

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[45] It is the date of the attachment of tax liability rather than payment of the tax that is determinative. *See ATA v. Smith*, 496 U.S. at 186-88. Thus, the fact that some taxes for taxable year 1988 may have been *paid* in 1989 after the March 1989 date of *Davis* is irrelevant.

[46] Indeed, the question presented by the Supreme Court for reargument in *McKesson* was whether a state must provide some form of retrospective relief when a taxpayer pays a state tax found to violate "clearly established law" under the Commerce Clause. *McKesson Corp. v. Division of Alcoholic Beverages and Tobacco*, 492 U.S. 915 (1989) (order requesting supplemental briefing). The issue presented was a narrow one.

such equitable principles are never to be considered in a case in which a tax is found to violate federal law.[47] Rather, the Court considered the state's equitable arguments and found them not to be "weighty" in a circumstance where the most critical equitable factor – a state's good faith reliance on a presumptively valid state statute – was absent.

Before *Davis*, the Commonwealth had no indication from prior judicial decisions or from any retired federal employees in Virginia that the taxes were of questionable validity. There were, to be sure, lobbying efforts for more favorable tax treatment to retired federal employees, but importantly there is no indication that they were at any time based on claims of legal invalidity of the tax. Moreover, the fact that retirees pursued legislative remedies and never pursued administrative or judicial remedies further confirmed that they conceived the issue to be one of policy, not legality. The Commonwealth had no reason in the tax years at issue here – 1985 through 1988 – to refrain from collecting the taxes or to escrow the

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[47] In fact, this Court has held that the federal government is not required to refund taxes paid without notice of challenge, despite a provision in the Internal Revenue Code authorizing the refund of taxes "wrongfully collected." *United States v. New York & Cuba Mail S.S. Co.*, 200 U.S. 488 (1906). *New York & Cuba Mail S.S. Co.* was cited in *United States v. Mississippi Tax Commission*, 412 U.S. 363, 368 n. 11 (1973), as authority for the proposition that recovery may be denied of taxes voluntarily paid pursuant to an illegal demand. In *New York & Cuba Mail Steamship Co.*, the United States conceded that a stamp tax was unconstitutional but argued that no recovery of the taxes paid was due because the tax was paid voluntarily and without protest. Although there were severe penalties for not paying the tax, at the time the tax was paid the Collector was not informed, orally or in writing, that the taxpayer claimed that the law was unconstitutional or that he was paying under duress. The Court concluded that such payment must be deemed voluntary and not subject to recovery. 200 U.S. at 494. This conclusion was not affected by a statutory provision authorizing the Commissioner of the Internal Revenue to "refund . . . and pay back all taxes . . . that appear to be unjustly assessed or excessive in amount, or *in any manner wrongfully collected*." *Id.* at 495 (emphasis in original). The taxpayer argued that this provision rendered protest or notice unnecessary for his protection. The Court disagreed, holding that protest or notice, while not statutorily required, "was clearly demanded for the protection of the government in conducting the extensive business of dealing in stamps, which were sold and delivered in quantities, and without it there would not be the slightest vestige of involuntary payment." *Id.*

taxes collected.[48] The General Assembly took immediate action following *Davis* to align Virginia's tax system with the requirements of that decision. Petitioners accordingly have received the benefit of that decision for all tax years since *Davis* and will continue to do so. Due process does not require that they receive any more than that.

Due process is founded on notions of fundamental fairness and a balancing of the governmental and private interests in each case. *Mathews v. Eldridge*, 424 U.S. 319 (1976); *Wolff v. McDonnell*, 418 U.S. 539 (1974). It would be fundamentally unfair to the taxpayers of the Commonwealth for the Court to hold in this case that, despite its factual differences from *McKesson*, due process requires a retrospective remedy. A balance of the equities supported backward-looking relief in *McKesson*; it supports prospective only relief in this case.

(2) *The decision below is consistent with* ATA v. Smith. The limitation of the remedy here to the prospective relief already obtained by Petitioners is also consistent with both this Court's decision and its dissent in *ATA v. Smith*. The plurality opinion in that case adheres to *Chevron Oil*, and under that test no refunds are required here. The dissent does not dispute the propriety of denying retroactive relief in an appropriate case:

[48] The Court noted that Florida could have refrained from collecting the taxes once they had been declared unconstitutional by the state court, pending further review, or could have placed the challenged taxes in an escrow account during this period. *McKesson*, 496 U.S. at 44-46. Had it done so, it would not then have faced the possibility of economic disruption. These options were not available to the Commonwealth. Unlike the taxpayers in *McKesson*, who challenged the Florida tax shortly after it was enacted, the taxpayers in this case had paid the taxes without protest during the period at issue. Payment under protest is not required in Virginia to preserve a taxpayer's right to seek a refund. However, the absence of any protest when the means to protest are clearly available to the taxpayer under state law is a factor supporting the conclusion that the Commonwealth, unlike Florida in *McKesson*, was justified in relying on the validity of its statute prior to *Davis*.

> [A]dherence to legal principle requires that we determine the rights of litigants in accordance with our best current understanding of the law. That current understanding may include judicial principles of res judicata and *stare decisis* and legislatively prescribed statutes of limitations that protect interests in reliance and repose. It may also include a law of damages that recognizes reliance interests.

496 U.S. at 214 (Stevens, J., dissenting).[49] It adopts the view expressed by Justice Harlan in *United States v. Estate of Donnelly*, 397 U.S. 286 (1970), in explaining the distinction between retroactivity as a choice of law principle and "the recognition of reliance as an element of the damages determination after a new principle of law has been applied." *Id.* As Justice Harlan stated:

> The impulse to make a new decisional rule nonretroactive rests, in civil cases at least, upon the same considerations that lie at the core of *stare decisis*, namely to avoid jolting the expectations of parties to a transaction. Yet once the decision to abandon precedent is made, I see no justification for applying principles determined to be wrong, be they constitutional or otherwise, to litigants who are in or may still come to court. . . .
>
> To the extent that equitable considerations, for example, "reliance," are relevant, I would take this

[49] The dissent described *Chevron Oil* as "establish[ing] a remedial principle for the exercise of equitable discretion by federal courts and not, as the plurality states, a choice of law principle applicable to all cases on direct review." 496 U.S. at 220 (Stevens, J., dissenting). It offered a similar explanation for a series of other Supreme Court decisions that declined to award retroactive relief.

One is entitled to assume that if it is consistent with due process for the federal courts to consider equitable considerations as a basis for denying retroactive compensatory relief in appropriate cases, it is likewise consistent with due process for the state courts to do so. Thus, the theory of the *ATA* dissent – which recognizes the correctness of prior denials of retroactive relief by the federal courts and which remands remedial issues in the present context to state law in the first instance – fully supports the Virginia Supreme Court decision in this case. That decision withholds a state refund remedy on the basis of equitable considerations similar to those invoked in *Chevron Oil*. This is exactly what the dissent in *ATA* contemplates.

> into account in the determination of what relief is appropriate in any given case. There are, of course, circumstances when a change in the law will jeopardize an edifice which was reasonably constructed on the foundation of prevailing legal doctrine. Thus, it may be that the law of remedies would permit rescission, for example, but not an award of damages to a party who finds himself able to avoid a once-valid contract under new notions of public policy.

Estate of Donnelly, 397 U.S. at 295-97 (Harlan, J., concurring), quoted in *ATA v. Smith*, 496 U.S. at 214-15 (Stevens, J., dissenting). Certainly *Davis* represented a "change in the law" that jeopardized "an edifice which was reasonably constructed on the foundation of prevailing law." And, like Justice Harlan's rescission example, adjustment of the future relations of the parties is an appropriate and sufficient remedy in the present case. We know from the decision below that, given the balance of equitable considerations in this case, an "award of damages" in the form of a retrospective refund is not permitted under the state law of remedies. Federal law does not require a different result.

(3) Beam *does not require a retrospective remedy*. It can be added that the denial of a retrospective remedy is also fully consistent with this Court's decision in *Beam*. As Justice Souter's opinion announcing the judgment of the Court pointed out, the issue resolved in that case was "narrow." 111 S. Ct. at 2448. *Beam* rejected the concept of selective prospectivity. It did not speculate as to the bounds or propriety of pure prospectivity. And importantly:

> Nor do we speculate about the remedy that may be appropriate in this case; remedial issues were neither considered below nor argued to this Court, save for an effort by petitioner to buttress its claim by reference to our decision last Term in *McKesson*. As we have observed repeatedly, federal "issues of remedy . . . may well be intertwined with, or their consideration obviated by, issues of state law." *Bacchus*, 468 U.S., at 277. Nothing we say here deprives respondent of his opportunity to raise procedural bars to recovery under state law or demonstrate reliance interests entitled to consideration in determining the nature of the remedy that must be provided, a matter with which *McKesson* did not deal.

111 S. Ct. at 2448.

Here, unlike in *Beam*, remedial issues were fully considered below. The Virginia Supreme Court accepted the invitation in *Beam* to "consider[] . . . individual equities when deciding [the] remedial issues in [this] particular case[]." 111 S. Ct. at 2448. The court below applied established precedent that had resolved the matter under Virginia law in 1973. *Harper I*, 241 Va. at 241-42, 401 S.E.2d at 873-74 (SA 12-13). This state law basis for the decision below is entirely permissible under *Beam*, as well as *ATA v. Smith* and *McKesson*.

(4) *Section 111 does not require a retrospective remedy*. Petitioners argue that, nonetheless, the separation of powers doctrine requires that full retroactive effect must be given to *Davis* because any disposition other than full retroactivity would result in a judicial declaration of the effective date of a Congressional enactment. Indeed, Petitioners assert that this is the most "fundamental" reason that they are entitled to refunds. Pet. Br. at 4, 11-19.

But this argument, never made to the court below, plainly misses the mark. Section 111 says nothing at all about *remedies*. Whether looked at through the filter of the retroactive application of the decision in *Davis* or through the filter of equitable flexibility in the law of remedies, there is nothing in the language or history of § 111 that suggests that Congress addressed the question of what remedies, if any, should be provided in the event that its anti-discrimination principle were violated. Retrospective remedies have been eschewed by this Court in the face of congressional silence in contexts where other anti-discrimination principles have been at stake. *See, e.g., Norris*, 463 U.S. at 1105-07; *Manhart*, 435 U.S. at

718-23.[50] There is nothing in the text or history of § 111 to require a different result here.

Petitioners' argument is also wrong for another reason. It is common ground that Virginia's three year statute of limitations[51] is an adequate and independent state ground that forecloses any relief to retired federal employees for taxes prior to 1985. The principle underlying this conclusion must be that the text and history of § 111 do not require, under the Supremacy Clause, that the state interests of reliance and repose reflected in its statute of limitations be overridden by superior federal principles. There is no reason why a similar principle of reliance and repose cannot operate for the years in litigation here, 1985 through 1988. The state law of remedies has been interpreted by the Virginia Supreme Court below to be governed by equitable considerations that preclude the award of a retroactive refund remedy on the facts now before the Court. There is no reason in the text or history of § 111 – or in this Court's prior jurisprudence – why the state law of remedies cannot perform for the years 1985 through 1988 the function performed by the state statute of

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[50] Indeed, it does not follow, as Petitioners apparently would have it, that retrospective compensatory relief is the automatic corollary of a finding of unconstitutionality by this Court, even in areas where extremely important individual liberties are concerned. The school children who had been denied equal educational opportunities before *Brown v. Board of Education*, 347 U.S. 483 (1954), and the citizens whose votes had been diluted before *Reynolds v. Sims*, 377 U.S. 533 (1964), were never compensated retrospectively. There is a much less compelling case for such relief here. The unconstitutionality of which Petitioners complain does not find its origins in the personal rights of individual liberty protected by the Bill of Rights and the Fourteenth Amendment. *Davis* relied on a principle designed to order governmental relations, not the relations between citizen and government – a factor that distinctly weakens, if indeed it does not entirely eliminate, the compensatory interests that Petitioners can place on the scale of equities to be weighed in this case. The fact that Petitioners have *standing* to invoke the principle of intergovernmental immunity does not mean that they should have an interest in retrospective compensatory relief for unforeseeable changes in the law. The reasons for recognizing their standing to challenge the *Davis* tax are fully served by affording them the prospective relief which they have already received. The doctrine of intergovernmental immunity on which *Davis* relies has been fully vindicated.

[51] Va. Code § 58.1-1825.

limitations for the years 1942 through 1984. Both concepts were clearly announced features of Virginia law long before the *Davis* litigation arose. Neither is fundamentally unfair.

Petitioners themselves have recognized that it is appropriate for the state law of remedies to take equitable considerations into account. In their Petition for a Writ of Certiorari in this case, they said:

> Petitioners adopt the position taken by Justice Stevens in *American Trucking Assn's v. Smith*, 110 S. Ct. at 2350, i.e., that courts enjoy latitude in fashioning equitable remedies, but that in deciding substantive questions of law, they are bound "to determine the rights of litigants in accordance with [their] best current understanding of the law." Thus, *Chevron* analysis would be relevant only to determining, within constitutionally permissible bounds, an appropriate remedy.

Petition for Certiorari at 9. Equitable and reliance interests were the linchpin of the decision of the Supreme Court of Virginia. That decision is correct and should be affirmed.

C. The availability of a pre-payment remedy forecloses the need for a post-payment remedy.

A unanimous Court said in *McKesson* that the provision of a pre-payment opportunity to object to a tax obviated any due process obligation to provide a post-payment remedy. Specifically, the Court stated:

> [I]f a State chooses not to secure payments under duress and instead offers a meaningful opportunity for taxpayers to withhold contested tax assessments and to challenge their validity in a predeprivation hearing, payments tendered may be deemed "voluntary." The availability of a predeprivation hearing constitutes a procedural safeguard against unlawful deprivations sufficient by itself to satisfy the Due Process Clause, and taxpayers cannot complain if they fail to avail themselves of this procedure. See *Mississippi Tax Comm'n, supra*, 412 U.S., at 368, n.11, 93 S. Ct. at 2187, n.11 ("[W]here

> voluntary payment [of a tax] is knowingly made pursuant to an illegal demand, recovery of that payment may be denied").

McKesson, 496 U.S. at 38 n.21.

Taxpayers in Virginia are entitled to challenge a tax assessment in a pre-payment procedure set forth in §§ 58.1-1821 and 58.1-1822 of the Virginia Code.[52] Virginia Regulation § 630-1-1820 provides that § 58.1-1821 "may be used to protest any and all issues connected with an assessment." While § 58.1-1821 does not require a formal hearing, a taxpayer may present his position both in writing and in person.[53] There can be no doubt that this procedure satisfies minimum conditions of due process for an adequate opportunity to object in advance to the payment of a tax. *Cf. Mathews v. Eldridge*, 424 U.S. 319 (1976); *Goldberg v. Kelly*, 397 U.S. 254 (1970).

Petitioners argued below that the remedy provided by § 58.1-1821 is meaningless because the Tax Commissioner is without authority to declare a statute unconstitutional. Petitioners' argument, nevertheless, misses the point. The issue is not whether a taxpayer must be provided a "declaration" of unconstitutionality. The issue is whether a taxpayer may *obtain relief* from the payment of the tax prior to payment. He clearly may obtain such relief in Virginia. Sections 58.1-1821 and 58.1-1822 grant the Tax Commissioner the authority to determine whether an applicant is "erroneously or improperly assessed with any tax." Virginia Tax Regulation § 630-1-1820, as noted above, provides that an application for correction under § 58.1-1821 before payment "may be used to

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[52] Sections 58.1-1821 and 58.1-1822 are set forth at SA 20-21. They first appeared in Virginia law in 1928. See Ch. 26, 1928 Va. Acts 223.

[53] *See* Va. Reg. § 630-1-1821 (Application under § 58.1-1821 "will be handled within the Department [of Taxation] in the manner best determined by the Commissioner to resolve the dispute, which may include submission of additional documents and memoranda, further audit, holding a conference with the taxpayer or the taking of testimony."). This regulation is quoted in relevant part at SA 21-22. It has been in effect since January 1, 1985, with retroactive effect pursuant to Va. Code § 58.1-203.

protest *any and all* issues connected with an assessment." The Commissioner clearly has the authority to withhold any action to collect an assessment if he deems a statute unconstitutional, and in fact has done so in specific cases. Section 58.1-1822 also authorizes the Commissioner to exonerate the taxpayer from the payment of a tax. Further, § 58.1-105 authorizes the Tax Commissioner to "compromise and settle doubtful or disputed claims for taxes."

Thus, under Virginia law, if the Tax Commissioner determines that a tax is of doubtful validity, he can refrain from collecting the tax, exonerate the taxpayer from the payment of the tax, or compromise or settle the tax liability. These options provide a taxpayer a full and complete remedy, all without paying the tax. Of equal importance, an objection in this form would put the Commonwealth on notice *before* the payment of the tax that its legality was being contested. It is not appropriate for Petitioners to sandbag the State by withholding their objection, paying the tax, and then attempting to obtain a refund after the money is spent.[54]

Petitioners had a clear, meaningful, pre-payment opportunity to challenge the validity of the tax of which they now complain. They chose not to avail themselves of this remedy. It follows under the language of *McKesson* that they must be considered to have paid the challenged taxes voluntarily. Most importantly, *McKesson* makes it clear that due process does not now require an additional post-payment refund remedy in order to provide Petitioners the relief they could have obtained in advance of paying the tax.

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[54] Petitioners might object to use of the word "sandbag" here. But they could do so only by claiming that they did not know before *Davis* that the tax was invalid. Such a claim, it will be noticed, is inconsistent with the entire thrust of their brief, which argues that *Davis* did not establish "new" law because the law had been clear for years. They cannot have it both ways.

CONCLUSION

The issue in this case is whether there is room in federal law for the operation of equitable considerations that protect reliance interests and settled expectations in situations where this Court decides a case that is a surprise to the legal community. By any measure, *Davis* was a surprise. It declared unconstitutional a tax that had been in effect for almost 50 years and that had been paid by hundreds of thousands of taxpayers during that period. The rare legal challenges to the tax in other states prior to *Davis* resulted in decisions upholding the tax. There had been no challenge in Virginia to the legality of the tax. The most directly relevant (indeed only) precedent cited by this Court in *Davis* had been decided 29 years earlier, yet not even that case had led those with a self-interest in avoiding the tax to question the legal basis for the taxes paid to the Commonwealth of Virginia at any point between 1960 and 1989. Nonetheless, Petitioners claim refunds for four tax years during which they too thought the taxes were valid, as evidenced by the fact that they raised no objections to paying the tax (even though, under Virginia law, they had a pre-payment opportunity for doing so). They claim refunds in an amount that is the equivalent of a 22% increase in the sales tax to be paid by every Virginian or a 13.6% surcharge on the income tax bills of every citizen of the Commonwealth. Whether this sum is to be exacted by increased taxes or decreased services, it is unfair to ask the citizens of the Commonwealth to pay what, from any honest assessment, these Petitioners never thought they were owed. And it is unfair to the citizens of some 16 other states to require them to fund sums in excess of $1.8 billion for similar claims.

Rationales may differ. There are, as has been demonstrated above, two independent theories upon which refunds can appropriately be denied to these Petitioners. One is that *Davis* is not to be retroactively applied. The other is that the state law of remedies may appropriately take equitable considerations into account. Both theories permit the withholding of retrospective relief in the case of unforeseen decisions that

break new ground, that undermine legitimate reliance interests, and that upset the settled expectations of the parties. Petitioners have benefitted and will continue to benefit from the full effect of *Davis* for the tax year in which the decision was made and for all subsequent tax years. There is no reason to rewrite history by restoring to them (at the expense of innocent citizens) moneys which they and the Commonwealth reasonably thought were lawfully taxed when paid. The decision below should be affirmed.

Respectfully submitted,

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SUPPLEMENTAL APPENDICES

APPENDIX A

FISCAL IMPACT OF DAVIS

State	Projected Refund Liability Under State Statute of Limitations Period[1]
Alabama	$ 20 million
Arizona	$339 million[2]
Arkansas	$ 45 million
Georgia	$100 million
Iowa	$ 45 million
Kansas	$ 91 million
Kentucky	$ 74 million
Mississippi	$ 35 million
Montana	$ 20 million
New York	$ 55 million
North Carolina	$140 million[3]
Oklahoma	$ 20 million[4]
South Carolina	$200 million
Utah	$120 million
Virginia	$467 million
Wisconsin	$ 70 million
TOTAL	$1.841 billion

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[1] Unless otherwise noted, all amounts may be regarded as accurate estimates of potential liability for tax principal and accrued interest. The information contained in this chart was provided by each State's Department of Revenue or Taxation through its legal counsel in response to a telephone survey conducted by the Virginia Office of the Attorney General during the week of July 13-17, 1992.

[2] The Arizona Tax Court has issued a refund order using a partial refund formula whereby the State's liability is substantially less than this figure. This partial refund order is on appeal.

[3] This represents the amount alleged by federal retirees to be at issue in presently pending class action litigation.

[4] This amount represents tax liability exclusive of any interest.

Excerpts from the Virginia Appropriations Act for 1992-94, 1992 Va. Acts of Assembly, Chap. 893, approved April 15, 1992.

(pp. 99-108)

§ 1-49. UNIVERSITY OF VIRGINIA

* * *

Grand Total for University of Virginia
Fund Sources: General $139,653,891.00

* * *

§ 1-50. VIRGINIA POLYTECHNIC INSTITUTE AND STATE UNIVERSITY (208)

* * *

Grand Total for Virginia Polytechnic Institute and State University
Fund Sources: General $162,387,379.00

§ 1-51. VIRGINIA COMMONWEALTH UNIVERSITY (236)

* * *

Grand Total for Virginia Commonwealth University
Fund Sources: General $124,737,522.00

[Total Annual General Fund Appropriation for Virginia's Three Largest State Universities ..... $426,778,792.00]

(p. 216)
Item 535

* * *

Grand Total, Department of Corrections
Operating Funds, FY 93 ..... $402,458,009.00

Excerpt from *Virginia Summary, Executive Budget of the Commonwealth of Virginia, 1992-94*, submitted to the Virginia General Assembly on January 8, 1992.

(p. A-4)

Overview

* * *

Principal Features of the 1992-94 Budget

The proposed budget calls on Virginians to modify their expectations of state government's role, to accept that it cannot be "business as usual" at the state level, and to help reposition Virginia for the future. The Governor's 1992-94 budget is a plan to permanently reduce and reshape the Commonwealth's spending to fit a forecast calling for low to modest revenue growth. The proposed budget has these characteristics:

- It makes permanent spending reductions in the budget through proposals to downsize, consolidate, and eliminate state programs. Many agency budgets have been reduced, on average, nearly 25 percent below original 1990-92 funding levels.

* * *

Excerpts from *Monthly Revenue Report*, prepared by the Office of the Comptroller and provided to Paul W. Timmereck, Secretary of Finance, on August 11, 1992.

* * *

	FY 93 ESTIMATE
Net Individual Income Tax	$3,488,400,000.00
Sales and Use Tax	$1,434,000,000.00
[State portion = 3% tax]	

* * *

Local Portion Sales and Use Tax	$ 478,000,000.00
[Local portion = 1% tax]	

* * *

Transportation Portion Sales and Use Tax	$ 240,477,000.00
[Transportation portion = ½% tax]	

APPENDIX B

SUPREME COURT OF VIRGINIA

Record No. 900770

HENRY HARPER, *et al.*

v.

VIRGINIA DEPARTMENT OF TAXATION

Record No. 900792

LAWRENCE E. LEWY, *et al.*

v.

VIRGINIA DEPARTMENT OF TAXATION

From the Circuit Court of the City of Alexandria
DONALD H. KENT, Judge

Present: Carrico, C.J., Compton, Stephenson, Whiting, Lacy, and Hassell, JJ., and Cochran, Retired Justice

OPINION BY JUSTICE ROSCOE B. STEPHENSON, JR.

March 1, 1991

In *Davis v. Michigan Dept. of Treasury*, 489 U.S. 803 (1989), the Supreme Court of the United States declared that state taxation of pension income of retired federal government employees, while exempting from taxation pension income of retired state government employees, violated the doctrine of intergovernmental tax immunity embodied in the supremacy clause of the Constitution of the United States.

The Supreme Court, however, did not decide whether its decision in *Davis* had retrospective application.[1]

In these consolidated appeals, the appellants (collectively, Harper) are retired federal employees who receive either civil service retirement benefits or military retired pay. They filed suits in the trial court against Virginia Department of Taxation (the Commonwealth) in May 1989, seeking refunds, pursuant to Code § 58.1-1826, for state income taxes paid for tax years 1985, 1986, 1987, and 1988. After consolidating the several suits, the trial court ruled that *Davis* should be applied prospectively only and, therefore, that Harper was not entitled to the refunds. Harper appeals.

In this appeal, the principal issue is whether *Davis* should be applied only prospectively, thereby denying the refunds, or retroactively, thereby granting the refunds.

I

Whether a constitutional decision of the Supreme Court is applied retroactively is a matter of federal law. *American Trucking Associations, Inc. v. Smith*, ___ U.S. ___, ___, 110 S.Ct. 2323, 2330 (1990). In the civil context, retroactive application of such decisions is governed by the three-pronged test announced in *Chevron Oil Co. v. Huson*, 404 U.S. 97 (1971). *Smith*, ___ U.S. at ___, 110 S.Ct. at 2331, *see U.S. v. Johnson*, 457 U.S. 537, 563 (1982).

In *Smith*, the Supreme Court considered a state's taxing statute that previously had been declared unconstitutional under the commerce clause of the Federal Constitution.

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[1] The Supreme Court did not consider this issue because Michigan conceded that "to the extent appellant has paid taxes pursuant to this invalid tax scheme, he is entitled to a refund." *Davis*, 489 U.S. at 817.

___ U.S. at ___, 110 S.Ct. at 2329. The Court denied the claimant's request for a refund of taxes paid prior to an earlier decision that invalidated the taxing statute. *Id.* at ___, 110 S.Ct. at 2334. In so doing, a plurality of the Court employed the three-pronged *Chevron* test and concluded that its earlier decision should not be applied retroactively. The Court found that its earlier decision invalidating an Arkansas highway tax, *American Trucking Assns., Inc. v. Scheiner,* 483 U.S. 266 (1987), established a "new principle of law" under the commerce clause. *Id.* at ___, 110 S.Ct. at 2332. Arkansas's legislature, therefore, was justified in relying upon existing precedent and had "good reason to suppose" the enactment of the tax would not violate the Federal Constitution. *Id.* at ___, 110 S.Ct. at 2333.

Harper contends, nonetheless, that "because the taxes at issue here . . . constitute[d] an 'unconstitutional deprivation,' . . . Virginia must provide 'backward-looking relief' to the refund claimants." Harper asserts that such relief is required by the holding in *McKesson Corp. v. Division of Alcoholic Beverages and Tobacco,* ___ U.S. ___, 110 S.Ct. 2238 (1990).

In *McKesson,* decided the same day as *Smith,* the Supreme Court held that a "clear and certain remedy," which could include refunds, was required to remedy Florida's unconstitutional liquor tax statute. ___ U.S. at ___, 110 S.Ct. at 2252. In so holding, the Court rejected Florida's contention that its taxing authority implemented the tax preference scheme " 'in good faith reliance on a presumptively valid statute.' " *Id.* at ___, 110 S.Ct. at 2254. In rejecting that contention, the Court stated that the challenged tax statute "reflected only cosmetic changes from the prior version of the tax scheme that itself was virtually identical to the Hawaii scheme invalidated" in *Bacchus Imports, Ltd. v. Dias,* 468 U.S. 263 (1984). Thus, the Court concluded, Florida "[could] hardly claim surprise" when its later statute was invalidated. *Id.* at ___, 110 S.Ct. at 2255.

In the present case, nothing in the record suggests that the Commonwealth acted other than in good faith reliance upon a presumptively valid taxing statute. We conclude, pursuant to *Smith,* that the three-pronged *Chevron* test must be employed to determine whether the *Davis* decision should be applied prospectively only.

A.

For a decision to be applied prospectively only, the first prong of the *Chevron* test requires that the decision "establish a new principle of law, either by overruling clear past precedent on which litigants may have relied, . . . or by deciding an issue of first impression whose resolution was not clearly foreshadowed." 404 U.S. at 106. Satisfaction of this first prong usually has been stated as the "threshold test" for determining whether or not a decision should be applied prospectively only. *Johnson,* 457 U.S. at 550 n.12.

When *Davis* was decided, 23 states had statutes similar to the Michigan statute.[2] Virginia's statute had been in effect for almost half a century. *See* Acts 1942, c. 325. As far as the record shows, the federal pensioners had paid the tax without protest. Not a single federal pensioner had brought an action

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[2] *See* Ala. Code Sections 36-27-28 and 40-18-19 (Supp. 1988); Ariz. Rev. Stat. Ann. Section 43-1022 (Supp. 1988); Ark. Code Ann. Section 25-51-3206; Colo. Rev. Stat. Section 39-22-104(4)(f) and (g) (Supp. 1988); Ga. Code Ann. Section 48-7-27(a)(4)(A) (Supp. 1988); Iowa Code Ann. Section 97A.12 (West 1984); Kan. Stat. Ann. Section 74-4923(b) (1985); Ky. Rev. Stat. Ann. Section 16.690 (Michie/Bobbs-Merrill Supp. 1988); La. Rev. Stat. Ann. 47:44.1 (Supp. 1989); Mich. Comp. Laws Ann. Section 206.30 (1988); Miss. Code Ann. Section 25-11-129 (1972); Mo. Rev. Stat. Section 86.190 and 104.540 (1986); Mont. Code Ann. Section 15-30-111(2) (1987); N.M. Stat. Ann. Section 10-11-145 (1978); N.Y. Tax Law Section 612(c)(3) McKinney (1987); N.C. Gen. Stat. Section 135-9 (1988); Okla. Stat. tit. 68 § 2358 (1988); Ore. Rev. Stat. Section 316.680(1)(c) and (d) (1987); S.C. Code Section 12-7-435(a), (d), and (e) (Supp. 1988); Utah Code Ann. Section 49-1-608 (1989); Va. Code Section 58.1-322(C)(3) (Supp. 1988); W.Va. Code Section 11-21-12(c)(5) and (6) (Supp. 1988); Wis. Stat. Section 71.05(1)(a) (Supp. 1988).

during that period in a Virginia court seeking a refund of taxes on the basis of the intergovernment tax immunity doctrine. The absence of such litigation reasonably may be explained by examining the doctrine's origin and development.

The intergovernmental tax immunity doctrine had its genesis in *McCulloch v. Maryland,* 17 U.S. (4 Wheat.) 316 (1819). The doctrine was grounded on the proposition that "[s]tates have no power, by taxation or otherwise, to retard, impede, burden or in any other manner control, the operations [of the federal government]." *Id.* at 436.

The pre-*Davis* cases invalidating state taxing statutes were decided on the proposition that the tax had a foreseeable and direct effect on some operation of the federal government. *See, e.g., Memphis Bank & Trust Co. v. Garner,* 459 U.S. 392 (1983) (state tax that imposes greater burden on holders of federal obligations than on holders of similar state obligations impermissibly discriminates against securities issued by federal government); *Phillips Chemical Co. v. Dumas Indep. Sch. Dist.,* 361 U.S. 376 (1960) (state tax that imposes greater burden on lessees of federal property than on lessees of other exempt public property impermissibly discriminates against federal government). Indeed, *Davis* states that intergovernmental tax immunity is based on "the need to protect each sovereign's governmental operations from undue interference by the other." 489 U.S. at 814.

In the present case, it is difficult to discern how the General Assembly of Virginia should have been expected to perceive that a statutory scheme, exempting state pensioners from state taxation, would have placed any foreseeable and direct burden on some federal operation. Consequently, we conclude that the *Davis* decision established a new rule of a law by deciding an issue of first impression whose resolution was not clearly foreshadowed. Thus, the first prong of the *Chevron* test is satisfied.

B

The second *Chevron* prong requires a court to "weigh the merits and demerits in each case by looking to the prior history of the rule in question, its purpose and effect, and whether retrospective operation will further or retard its operation." 404 U.S. at 106-07. In applying this factor, we must determine whether the intergovernmental tax immunity doctrine will be retarded or furthered by retroactive application of the *Davis* decision.

The purpose of intergovernmental tax immunity is not to prevent legitimate state taxation. *See Smith,* ___ U.S. at ___, 110 S.Ct. at 2332. Virginia's taxing statute was legitimate until a new rule was announced in *Davis.* As soon as the General Assembly became aware of the *Davis* decision, it acted to correct the defects in its statute. *See* Acts 1989, Special Session II, c. 3. As a result, the purpose of the intergovernmental tax immunity doctrine already has been fully served, and applying *Davis* retroactively would do nothing either to retard or to further the doctrine's purpose. Therefore, the second prong of the *Chevron* test is satisfied.

C

The third prong of the *Chevron* test requires a court to "[weigh] the inequity imposed by retroactive application." 404 U.S. at 107. In weighing the equities, considerable deference must be accorded a state's reliance upon a statute that was presumptively valid. *See Lemon v. Kurtzman,* 411 U.S. 192 (1973). Indeed, "[i]t is well established that reliance interests weigh heavily in the shaping of an appropriate equitable remedy." *Id.* at 203. As Chief Justice Burger so aptly stated in *Lemon,* "statutory or even judge-made rules of law are hard facts on which people must rely in making decisions and in shaping their conduct. This fact of legal life underpins our modern decisions recognizing a doctrine of nonretroactivity." *Id.* at 199.

An important equitable consideration is the effect that retroactive application of a judicial decision may have on a state's financial stability. As the *Smith* plurality acknowledged, applying a judicial decision retroactively may "have potentially disruptive consequences for the State and its citizens. A refund, if required by state or federal law, could deplete the state treasury, thus threatening the State's current operations and future plans." ___ U.S. at ___, 110 S.Ct. at 2333.

In *Arizona Governing Committee v. Norris*, 463 U.S. 1073, 1105 (1983), the Supreme Court held that the State of Arizona's voluntary pension plan violated Title VII of the Civil Rights Act of 1964. The Court further held, however, that the state's liability would be prospective only. *Id.* The Court found that retroactive liability could cost the state hundreds of millions of dollars. As Justice Powell stated, "[i]mposing such unanticipated financial burdens would come at a time when many States and local governments are struggling to meet substantial fiscal deficits." *Id.* at 1106-07. Because the illegality of Arizona's actions had not been declared until *Norris* was decided, Justice Powell further stated that "[t]here is no justification for this Court . . . to impose this magnitude of burden retroactively on the public." *Id.* at 1107.

In the present case, the record discloses that retroactive application of the *Davis* decision would give rise to a potential tax refund liability, inclusive of interest, of approximately $440,000,000. This liability would come at a time when the Commonwealth is already struggling to meet enormous fiscal deficits. The record contains affidavits of Commonwealth officials that support the conclusion that allowing the requested refunds would have a potentially disruptive and destructive impact on the Commonwealth's planning, budgeting, and delivery of essential state services.

Harper contends, nonetheless, that "it is simply more equitable to place the financial consequences . . . upon the

government (and thus the whole body of taxpayers) than upon a small subclass of taxpayers who had unconstitutionally been forced to pay the tax in the first instance." Thus, Harper asserts, "taxpayers who have been paying more than their lawful share of taxes should be reimbursed by those who have paid less."

The Commonwealth counters by pointing out that "hundreds of thousands of other Virginia taxpayers have paid taxes on their private pension income but have no claim for monetary relief." The Commonwealth further asserts that "over 2.5 million Virginians annually have paid their 'fair share' of taxes while only some sixty thousand state and local retirees were excluded from pension income taxation."

The record supports the Commonwealth's assertions, and we conclude that, on balance, the equities weigh heavily in favor of the Commonwealth. Consequently, the third prong of the *Chevron* test is satisfied.

Accordingly, we hold that, under the *Chevron* test, the *Davis* decision is not to be applied retroactively. *Accord Bass v. State*, 395 S.E.2d 171 (S.C. 1990).

II

Harper contends, nonetheless, that the refunds are due as a matter of state law. He relies upon Code §§ 58.1-1825 and -1826. Code § 58.1-1825 provides that "[a]ny person assessed with any tax administered by the Department of Taxation and aggrieved by any such assessment may . . . within three years from the date such assessment is made, apply to a circuit court for relief." Code § 58.1-1826 provides, in pertinent part, as follows:

> If the court is satisfied that the applicant is erroneously or improperly assessed with any taxes, the court may order that the assessment be corrected. If the assessment exceeds the proper amount, the court may order that the applicant be

> exonerated from the payment of so much as is erroneously or improperly charged, if not already paid and, if paid, that it be refunded to him. If the assessment is less than the proper amount, the court shall order that the applicant pay the proper taxes and to this end the court shall be clothed with all the powers and duties of the authority which made the assessment complained of as of the time when such assessment was made and all the powers and duties conferred by law upon such authority between the time such assessment was made and the time such application is heard. The court may order that any amount which has been improperly collected be refunded to such applicant.

Harper asserts that, even if the *Davis* decision applies prospectively only, the federal retirees are entitled to refunds under Code § 58.1-1826. Harper argues that, because the assessments are unconstitutional, they also are "erroneous or improper."

We reject this argument. We hold that, because the *Davis* decision is not to be applied retroactively, the pre-*Davis* assessments were neither erroneous nor improper within the meaning of Code § 58.1-1826.

Harper's state-law contention also fails for another reason. We previously have held that this Court's ruling declaring a taxing scheme unconstitutional is to be applied prospectively only. *Perkins v. Albermarle County*, 214 Va. 240, 198 S.E.2d 626, *aff'd and modified on rehearing*, 214 Va. 416, 200 S.E.2d 566 (1973).[3] We adhere to our holding in

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[3] The case of *Capehart v. City of Chesapeake*, No. 5459 (Circuit Court, City of Chesapeake, decided Oct. 16, 1974), followed *Perkins*. In *Capehart*, more than one hundred taxpayers in the City of Chesapeake, who had been subjected to the same practice that was invalidated in *Perkins*, brought suit in circuit court seeking, among other things, refunds of the taxes "illegally and unconstitutionally assessed." The City demurred, citing *Perkins*. The circuit court sustained the demurrer, being of opinion that the case was controlled by *Perkins*. We denied Capehart's petition for appeal. 215 Va. xlvii, and Capehart's petition for certiorari raising due process grounds was denied by the Supreme Court, 423 U.S. 875 (1975).

Perkins. In so doing, we follow the criteria stated in *Fountain v. Fountain*, 214 Va. 347, 348, 200 S.E.2d 513, 514 (1973), *cert. denied*, 416 U.S. 939 (1974), that "consideration should be given to the purpose of the new rule, the extent of the reliance on the old rule, and the effect on the administration of justice of a retroactive application of the new rule." *See also Quick v. Harris*, 214 Va. 632, 634, 202 S.E.2d 869, 871 (1974), *cert. denied*, 420 U.S. 907 (1975).

III

Finally, Harper contends that "even if *Davis* were applied prospectively only, refunds for 1988 taxes would nonetheless be due, for they were not assessed, and in many cases were not paid, until *after Davis* was decided." (Emphasis in original.) *Davis* was decided on March 28, 1989. The last day for filing individual income tax returns for the 1988 taxable year was May 1, 1989. Harper claims that the last day for filing income tax returns is the date on which income taxes are assessed for the preceding year.[4] We do not agree.

Income taxes are "imposed on the Virginia taxable income *for each taxable year* of every individual." Code § 58.1-320. (Emphasis added.) The taxable year ended on December 31, 1988, almost three months before *Davis* was decided. When the year ended, the 1988 tax was fixed and ascertainable. Only payment of the tax was delayed until May 1, 1989. Code § 58.1-341.

The Supreme Court rejected a similar contention in *Smith*. The Court reasoned that tax liability depends upon the

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[4] Harper's reliance upon Code § 58.1-1820 is misplaced. Section 58.1-1820 defines "assessment" as that term is used in Article 2 of Chapter 18, which establishes limitation periods for various forms of relief. Individual income tax liability is established in Article 2 of Chapter 3.

" 'occurrence of the taxed transaction or the enjoyment of the taxed benefit, not the remittance of the tax.' " *Smith*, ___ U.S. at ___, 110 S.Ct. at 2335. As Justice O'Connor observed,

> [a] contrary rule would give States a perverse incentive to collect taxes far in advance of the occurrence of the taxable transaction. It would also penalize States that do not immediately collect taxes, but nevertheless plan their operations on the assumption that they will ultimately collect taxes that have accrued.

Id. at 2336.[5]

In sum, we hold that, (1) under the *Chevron* test, the *Davis* decision is not to be applied retroactively, (2) state law does not require tax refunds, but to the contrary, grants prospective-only application to decisions that invalidate a taxing scheme, and (3) our denial of refunds includes taxes due for the tax year 1988. Accordingly, the trial court's judgment will be affirmed.

Record No. 900770 – *Affirmed.*

Record No. 900792 – *Affirmed.*

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[5] For the same reason, we reject the contention in *Lewy* (Record No. 900792) that the trial court erred in denying injunctive relief that would have barred the Commonwealth from filing any action to collect taxes from those who, after the *Davis* decision, had refused to pay the 1988 taxes.

SUPREME COURT OF VIRGINIA

Record No. 900770

Present: All the Justices

HENRY HARPER, *et al.*

v.

VIRGINIA DEPARTMENT OF TAXATION

Record No. 900792

LAWRENCE E. LEWY, *et al.*

v.

VIRGINIA DEPARTMENT OF TAXATION

On Remand from the Supreme Court of the United States

OPINION BY JUSTICE ROSCOE B. STEPHENSON, JR.

November 8, 1991

These cases are before us again, having been remanded for our further consideration from the Supreme Court of the United States, ___ U.S. ___, 111 S.Ct. 2883 (1991).

In *Davis v. Michigan Dept. of Treasury*, 489 U.S. 803 (1989), the Supreme Court decided that state taxation of pension income of retired federal government employees, while exempting from taxation pension income of retired state government employees, violated the doctrine of intergovernmental tax immunity embodied in the supremacy clause of the Constitution of the United States. The appellants in the present case (collectively, Harper) filed suits for tax refunds

pursuant to Code § 58.1-1826, claiming that the Commonwealth unconstitutionally taxed their federal retirement incomes and that state law requires the refund of those taxes collected during the three-year period preceding the *Davis* decision.

On March 1, 1991, we held that the *Davis* decision is not to be applied retroactively, and accordingly, Harper was not entitled to a refund. *Harper v. Virginia Department of Taxation*, 241 Va. 232, 401 S.E.2d 868 (1991). In so doing, we applied the three-pronged test announced in *Chevron Oil Co. v. Huson*, 404 U.S. 97 (1971). On June 28, 1991, the Supreme Court vacated our March 1, 1991 decision and remanded these cases to us "for further consideration in light of *James B. Beam Distilling Co. v. Georgia*, 501 U.S. ___, 111 S.Ct. 2439 (1991)."

The Georgia taxing statute at issue in *Beam* imposed an excise tax on imported alcohol and distilled spirits at a rate double that imposed on alcohol and distilled spirits manufactured from products grown in Georgia. After the decision in *Bacchus Imports, Ltd. v. Dias*, 468 U.S. 263 (1984), in which the Supreme Court held that a Hawaii taxing statute that distinguished between alcoholic products imported from other states and locally manufactured alcoholic products violated the commerce clause of the Federal Constitution, James B. Beam Distilling Company, a Delaware corporation and Kentucky bourbon manufacturer, brought suit in a Georgia trial court, claiming that the Georgia statute likewise was violative of the commerce clause. The distilling company sought a full refund of the taxes paid for the taxable years 1982, 1983, and 1984. Relying upon *Bacchus*, the Supreme Court of Georgia held that the Georgia statute was unconstitutional. The Georgia court, however, refused to apply its ruling retroactively, thereby denying the requested refund. In so doing, the court applied the *Chevron Oil* test. *Beam*, 501 U.S. at ___, 111 S.Ct. at 2442.

The question presented in *Beam* was whether the new rule of law announced in *Bacchus* "should apply retroactively to claims arising on facts antedating that decision." *Id.* at ___, 111 S.Ct. at 2441. The Supreme Court reversed the Georgia court's judgment and remanded the case for further proceedings. *Id.* at ___, 111 S.Ct. at 2448.

The plurality opinion in *Beam* was authored by Justice Souter and joined by Justice Stevens. Justice Souter concluded that *Beam* involved retroactivity as a choice-of-law issue rather than as a remedial issue. *Id.* at ___, 111 S.Ct. at 2443. Justice Souter then set forth three possible solutions to the choice-of-law problem. First, a decision announcing a new rule of law may be made fully retroactive by applying the new rule both to the parties before the court and to all others by and against whom claims are made without regard to when such claims arise. Second, such a decision may be made purely prospective by applying the new rule of law only to cases arising on facts postdating the pronouncement. Third, the new rule could be applied to the parties before the court and the old rule could be applied to all other cases arising on facts predating the decision. *Id.* at ___, 111 S.Ct. at 2443-44. This third possibility, called "modified, or selective, prospectivity," was abandoned in the criminal context in *Griffith v. Kentucky*, 479 U.S. 314, 328 (1987). *Beam*, 501 U.S. at ___, 111 S.Ct. at 2444-45. Justice Souter rejects this concept in the civil context. *Id.* at ___, 111 S.Ct. at 2447.

After concluding that the Supreme Court in *Bacchus* had applied its new rule to the litigants there before the court, Justice Souter stated the following:

> Thus, the question is whether it is error to refuse to apply a rule of federal law retroactively after the case announcing the rule has already done so. We hold that it is, principles of equality and *stare decisis* here prevailing over any claim based on a *Chevron Oil* analysis.

Id. at ___, 111 S.Ct. at 2446.

The present case, however, is distinguishable from *Beam*. Although the Supreme Court in *Bacchus* applied its rule retroactively to the litigants in that case, the Court made no such ruling in *Davis*. Indeed, the issue of retroactivity was not considered by the Supreme Court in *Davis* because Michigan previously had agreed to the payment of a refund to Davis if its taxing scheme were invalidated. 489 U.S. at 817.

In order for a case to be precedent for another case, the court in the first case must have decided the issue presented in the second case. *United States v. L.A. Tucker Truck Lines*, 344 U.S. 33, 37-38 (1952); *United States v. Mitchell*, 271 U.S. 9, 14 (1926); *Webster v. Fall*, 266 U.S. 507, 511 (1925). Therefore, because the retroactivity issue was not decided in *Davis*, we are not foreclosed by precedent from applying the three-pronged *Chevron Oil* test in deciding the retroactivity issue in the present case.* *Accord Swanson v. North Carolina*, 329 N.C. 576, 586, 407 S.E.2d 791, 796 (1991).

Moreover, as Justice Souter stated in Part IV of the plurality opinion, the grounds for the *Beam* decision are narrow. 501 U.S. at ___, 111 S.Ct. at 2448. "[The grounds] are confined entirely to an issue of choice of law: when the Court has applied a rule of law to the litigants in one case it must do so with respect to all others not barred by procedural requirements or res judicata." *Id.* at ___, 111 S.Ct. at 2448.

Beam is important not only for what it decided but also for what it did not decide. As Justice Souter wrote:

> We do not speculate as to the bounds or propriety of pure prospectivity.

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* Furthermore, we do not read *Beam* as rejecting the *Chevron Oil* test. Four Justices clearly embrace the test's application in determining retroactivity. Two Justices reject the test, but only in its application to the choice-of-law issue. Only three Justices completely reject the test.

> Nor do we speculate about the remedy that may be appropriate in this case; remedial issues were neither considered below nor argued to this Court- . . . . Nothing we say here deprives respondent of his opportunity to raise procedural bars to recovery under state law or demonstrate reliance interests entitled to consideration in determining the nature of the remedy that must be provided. . . .

Id. at ___, 111 S.Ct. at 2448 (citations omitted).

Consequently, having reconsidered our March 1, 1991 decision in light of *Beam*, we conclude that nothing articulated in *Beam* requires a result different from that reached in our prior decision. Accordingly, we reaffirm our prior decision in all respects.

Affirmed.

APPENDIX C

Report of the

House Finance Retirement Subcommittee

To

The Governor and the General Assembly of Virginia

Richmond, Virginia

December, 1982

To: Honorable Charles S. Robb, Governor of Virginia

and

The General Assembly of Virginia

CHARACTERISTICS OF SELECTED VIRGINIA RETIREES

Category	Average Retirement	Number
Federal Civil Service	$ 15,416	74,932
Military	$ 14,454 ($ 21,406 officers) ($ 9,494 enlisted)	76,880
VSRS (state employees)	$ 4,020	13,905

EXCERPTS FROM THE VIRGINIA INCOME TAX LAW AND REGULATIONS

§ 58.1-1821. Application to Tax Commissioner for correction. – Any person assessed with any tax administered by the Department of Taxation may, within ninety days from the date of such assessment, apply for relief to the Tax Commissioner. Such application shall be in the form prescribed by the

Department, and shall fully set forth the grounds upon which the taxpayer relies and all facts relevant to the taxpayer's contention. The Tax Commissioner may also require such additional information, testimony or documentary evidence as he deems necessary to a fair determination of the application.

On receipt of a notice of intent to file under this section, the Tax Commissioner shall refrain from collecting the tax until the time for filing hereunder has expired, unless he determines that collection is in jeopardy.

Any person whose tax assessment has been improperly collected by the Department may apply hereunder to assert a claim that any amount so collected was exempt from process.

§ 58.1-1822. Action of Tax Commissioner on application for correction. – If the Tax Commissioner is satisfied, by evidence submitted to him or otherwise, that an applicant is erroneously or improperly assessed with any tax administered by the Department of Taxation, the Tax Commissioner may order that such assessment be corrected. If the assessment exceeds the proper amount, the Tax Commissioner shall order that the applicant be exonerated from the payment of so much as is erroneously or improperly charged, if not already paid into the state treasury, and, if paid, that it be refunded to him. If the assessment is less than the proper amount, the Tax Commissioner shall order that the applicant pay the proper taxes. He shall refund to the taxpayer any exempt funds which have been improperly collected. The Tax Commissioner shall refrain from collecting a contested assessment until he has made a final determination under this section unless he determines that collection is in jeopardy.

Va. Reg. § 630-1-1820. In general; definitions.

A. Types of remedies. Article 2, Chapter 18, Code of Virginia 1950, as amended, provides several administrative and judicial remedies for taxpayers who believe an assessment to be erroneous. In addition, Va. Code § 58.1-105

authorizes the Commissioner to accept an offer in compromise in certain circumstances. The various remedies available for taxes administered by the department may be summarized as follows:

1. Offer in compromise under § 58.1-105, which may be used to waive or compromise a penalty for good cause or to compromise a tax based on a doubtful or disputed claim or a liability of doubtful collectibility.

2. Application for correction for an erroneous assessment under § 58.1-1821 before payment of the assessment, which may be used to protest any or all issues connected with an assessment.

3. Amended return claiming a refund under § 58.1-1823, which may be used to amend a return based upon new or newly discovered facts such as errors discovered in the original return or a change in federal taxable income.

4. Protective claim under § 58.1-1824 after payment of the assessment, which may be used to protest any or all issues connected with an assessment and, in certain circumstances, may extend the time in which taxpayer may apply to a court.

5. If the above administrative remedies are not satisfactory to the taxpayer, the assessment may be paid and an application to a court made under § 58.1-1825.

B. Exhaustion of administrative remedies. Although not required by law, taxpayers are encouraged to exhaust their administrative remedies before resorting to litigation. Administrative reviews remain confidential pursuant to §§ 58.1-3 and 58.1-204. Even if a dispute cannot be resolved administratively, the issues in dispute may be significantly narrowed allowing expeditious court review.

* * *

Va. Reg. § 630-1-1821. Application for correction (before payment).

A. Application.

1. A taxpayer may apply to the Commissioner for correction of an erroneous assessment before payment of the assessment. . . . The application will be handled within the Department in the manner best determined by the Commissioner to resolve the dispute, which may include submission of additional documents and memoranda, further audit, holding a conference with the taxpayer or the taking of testimony. . . .

. . .

B. Collection and billing. When an application has been duly filed the Commissioner will not take any action to collect the tax, penalty and interest assessed unless he determines that collection is in jeopardy. . . .